WATERLOO CAPITAL

OUTLOOK 2025

Gravity's Edge

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2025 Introduction

A Letter from the Investment Team:

Last year, markets and the economy defied gravity, climbing higher even as elevated interest rates generated heavy drag. Equities soared, duration suffered, and businesses remained remarkably healthy. Now, in 2025, we stand at Gravity's Edge, a horizon where segments of the market will be tested to assess which have the thrust to achieve escape velocity, propelling further growth, and what areas risk burning up upon reentry.

After navigating turbulence in recent years, the U.S. economy accomplished what many thought improbable – a soft landing. **In a cycle unlike any other, structural forces, like artificial intelligence (AI) and fiscal spending, are providing a new lift to the traditional playbook.** AI stands as the new rocket on the launchpad, with promises to revolutionize productivity and reshape corporate America. We believe this trend positions U.S. markets favorably, propelled by the massive scale of investment, though the extent of its power and how much is priced-in remains foggy.

Meanwhile, the engines of U.S. growth, though less powerful, appear primed to maintain the economy's altitude in 2025. Above trend expansion continues, fueled by a resilient consumer and a labor market that has delivered 48 months of consecutive job gains. **Inflation has cooled to below 3%, but the Fed's work is not done.**

Inflation returned to Earth's atmosphere early last year but failed to fully burn back to the Federal Reserve's 2% target. Despite what the committee considered aggressive policy; core inflation remains stubbornly high.

The Fed appears to be chasing a proverbial ghost, the neutral rate, which has likely risen materially and is dampening the effectiveness of their key policy tool. With upward pressures afoot, we believe achieving inflation near 2.5% would be a win for the Fed in 2025. We are plotting a trajectory that suggests slower, yet positive growth. This, accompanied by inflation well above target, leads us to believe **rate cuts will be off the table for most of the year.**

Last year, Wall Street predicted a strong year for bonds, but they never made it off the launchpad. In 2025, rates seem to be reaching cruising altitude, held aloft by structural forces like ballooning government debt, persistent deficits, and imbalances in supply and demand. The re-emergence of the term premium has further boosted pressure on yields, recently driving rates back to one-year highs. As growth slows and inflation eases, the critical question becomes whether these forces will generate enough friction to push yields lower, or if structural pressures will keep them elevated. **For now, we believe that extending duration in the U.S. appears premature.**

Stock markets are flying high, with valuations stretched to stratospheric heights. **The P/E ratio, equities' gravitational constant, weighs heavier than ever on investors.** Yet, earnings in the new year could serve as rocket fuel, supporting these valuations and powering prices higher. If this momentum continues, fears of a crash landing may prove to be overblown.

Meanwhile, the Magnificent 7 (Mag 7) have enjoyed another year of dominance, thanks to their strong market positions and exceptional financial efficiency. However, the engine of their outperformance may decelerate in 2025. **This year could mark a long-awaited inflection point,** where earnings acceleration from the forgotten companies pulls more participants into the Mag 7's orbit, broadening market leadership.

Equity investors will keep a close eye on the bond market this year. If yields stabilize at lower levels, it could give stocks a bit more breathing room and a little extra lift. However, it's important to remember that markets are richly priced compared to history. **In 2025, we think mid-to-high single-digit returns are a fair expectation, but don't expect the smooth ride we had in 2024.** Instead, investors should brace for more turbulence along the way.

Closure

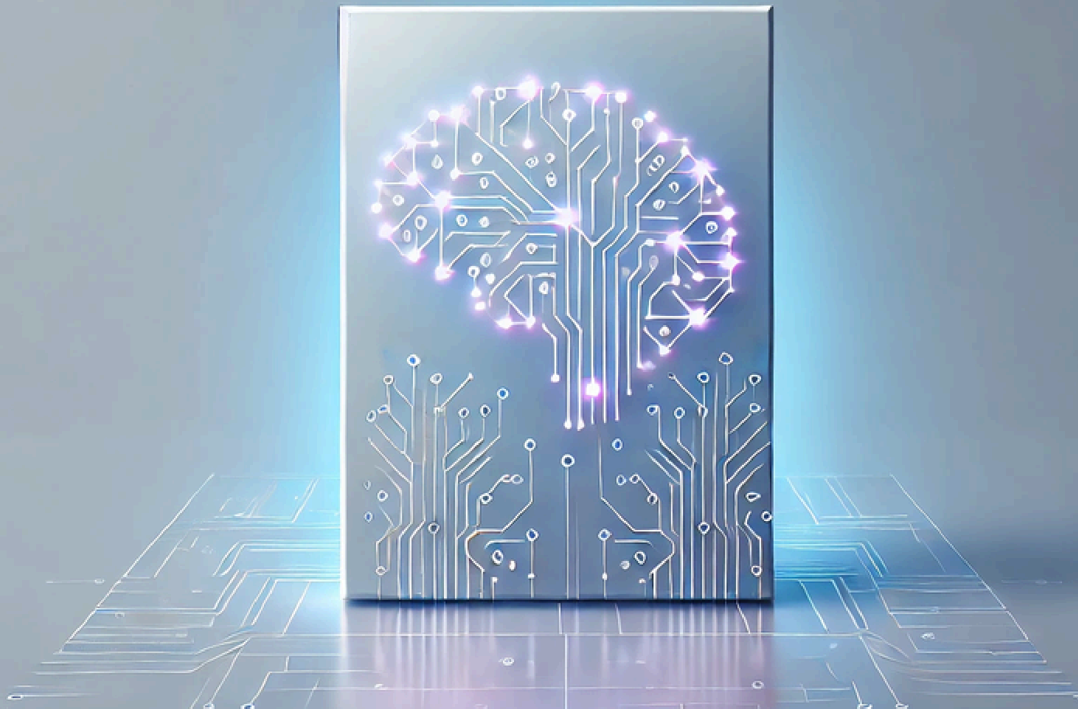
> Looking back on last year, it all seemed so straightforward, as the trajectory appeared smooth, the decisions obvious, and the path inevitable. But that's the deceptive beauty of hindsight. As we reviewed our outlook from last year and the extensive research that informed it, the reality was far less certain.

Heading into 2024, the narrative from strategists predicted a seemingly imminent recession, expectations of nearly seven cuts from the Federal Reserve, a resurgence of bonds as a dominant force in portfolios, and skepticism that equity markets could sustain their 2023 momentum under the weight of higher interest rates and stretched valuations. Navigating these uncertainties was anything but straightforward. Markets defied these predictions, showcasing resilience and once again proving how challenging it is to accurately chart their course.

Price targets and forecasts, while valuable guideposts, often mask the unpredictability of the interwoven forces at play. **On Wall Street, optimism often rules predictions, but reality tends to settle somewhere in-between.** While returns may fall short of the high benchmarks set in recent years, careful navigation and a willingness to adjust course can uncover opportunities for those prepared to seize them in 2025.

In this market outlook we present 6 key themes and their investment implications to provide a roadmap for investors this year. This body of work represents our best thinking at the time of writing and the investment team continually evaluates incoming information to adjust our projections and portfolios. On behalf of our team at Waterloo Capital, we want to thank you for reading our 2025 Market Outlook – *Gravity's Edge: Teetering Between Ascent and Reentry.*

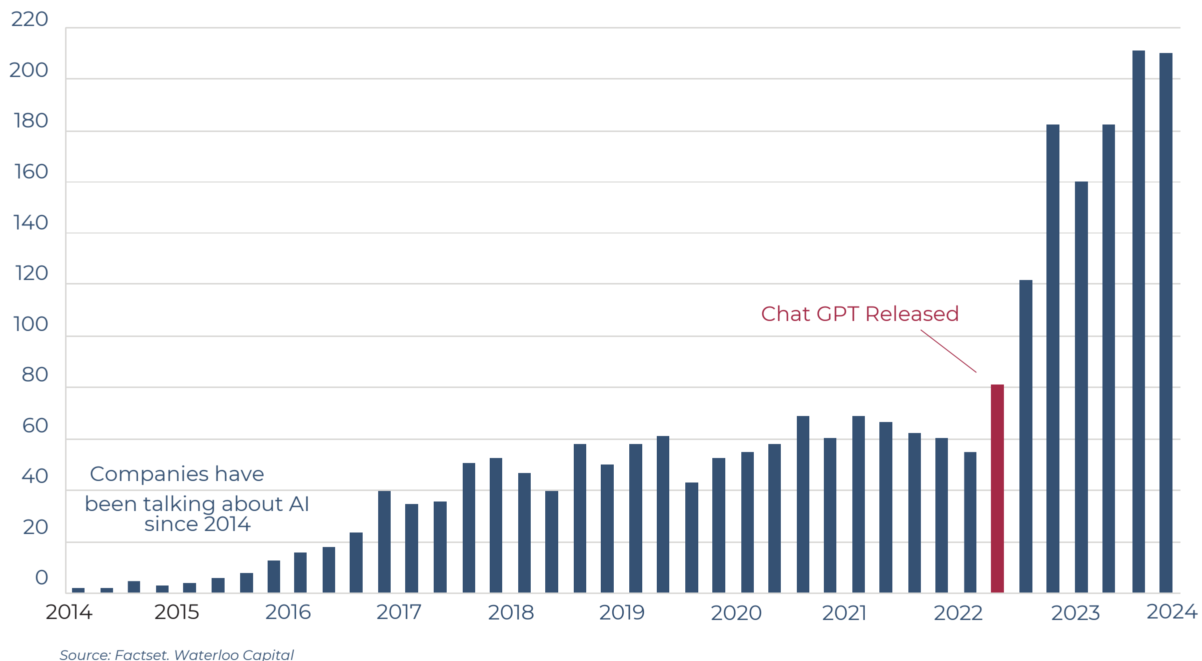
ARTIFICIAL INTELLIGENCE: NOT YOUR GRANDPA'S TECH BOOM



AI isn't just a buzzword anymore, it's a transformative force defining our era. As this technology reshapes the way we live and work, it carries the weight of both immense potential and profound uncertainty. History has shown that technological revolution brings both opportunities and challenges, and AI is no exception. Will it usher in an era of unprecedented growth, or will the hurdles of adaptation and sustainability slow its momentum?

One thing is certain: the AI revolution has arrived, and its impact is only just beginning to unfold.

Artificial Intelligence (AI) has witnessed explosive growth over the past few years, evolving from niche technology to one of the most transformative forces in the global economy. While AI has long been a part of technological discourse, its prominence has skyrocketed over the past decade. Just ten years ago, only a handful of companies touched on the topic during earnings calls. By 2024, over 40% of S&P 500 companies mentioned it. While this enthusiasm may temper somewhat in 2025, the opportunities within AI remain immense.



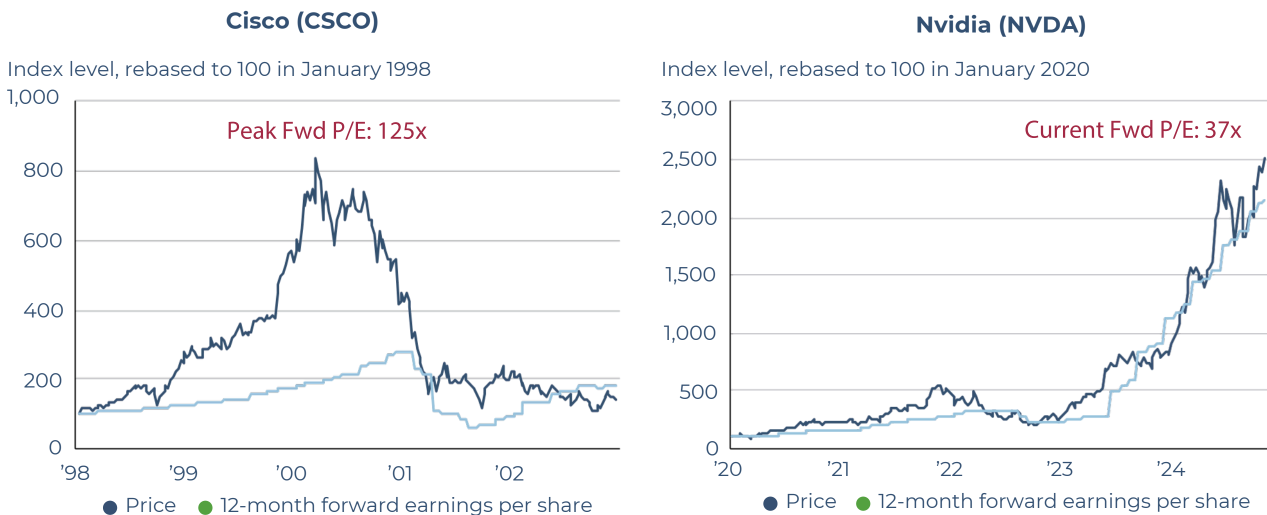
Source: Factset. Waterloo Capital

Without question, the AI boom is here, yet it raises countless questions about its potential, its risks, and, most importantly, its impact on markets. The biggest storyline has been drawing parallels between today's artificial intelligence revolution and the dot-com era of the late 1990s. And these similarities are hard to ignore as both represent transformative technological waves that reshaped industries and investor behavior. What's important is that unlike the speculative frenzy of the dot-com boom, where companies could simply add ".com" to their names to ride the hype, this AI cycle is being driven by tangible earnings and measurable productivity gains.

Take NVIDIA for example. the company has been at the center of this era of innovation, thanks to its advanced GPUs that power everything from ChatGPT ChatGPT to autonomous vehicles. This dominance has fueled its meteoric stock performance, reminiscent of Cisco's rise during the 1990s. However, the key difference lies in valuation and earnings. While Cisco traded at a lofty forward P/E of over 125x at the height of the dot-com bubble, NVIDIA's current forward P/E is comparatively modest at 37x. Wall Street's optimism for NVIDIA is anchored in real earnings growth as AI infrastructure continues to expand globally. This is not just speculative enthusiasm; it is a bet on the tangible value AI is already delivering to businesses globally.

> "This AI cycle is being driven by tangible earnings and measurable productivity gains."

2000's Showed Price-Earnings Decoupling: Today Tells a Different Story



Source: IBES, LSEG Datastream, J.P. Morgan Asset Management, Waterloo Capital, Chart Data as of November 12, 2024. NVDA's current P/E as of January 2025.

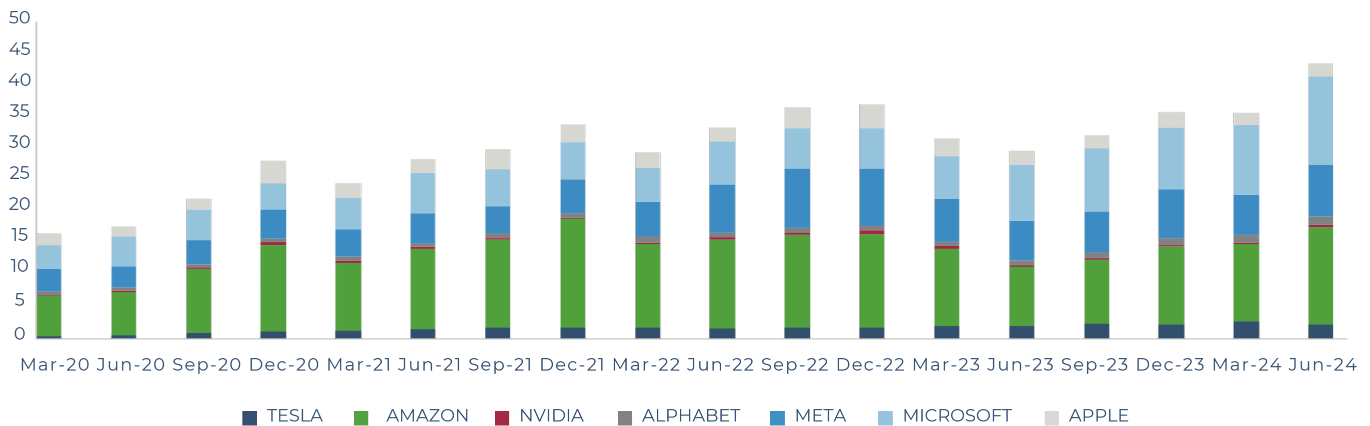
The comparisons to the dot-com era serve as a cautionary tale, but they emphasize the importance of focusing on the concrete catalysts and observable opportunities that extend far beyond one single company or sector. The AI ecosystem is rapidly evolving, with infrastructure development accelerating to support this new technological movement.

At the forefront are the "Magnificent Seven" tech giants, collectively investing $50 billion annually in capital expenditures to develop AI capabilities. These investments are supercharged by fiscal incentives such as the CHIPS Act, which aims to strengthen domestic semiconductor production and innovation. The story of AI does not end with these preeminent names. Data centers, energy providers, and industrial suppliers are poised to ride this multiyear investment cycle as AI infrastructure expands and matures.

The Magnificent Seven are Approaching $50 billion in Combined Capital Spending

CAPITAL SPENDING OF THE MAGNIFICENT SEVEN

$ billion

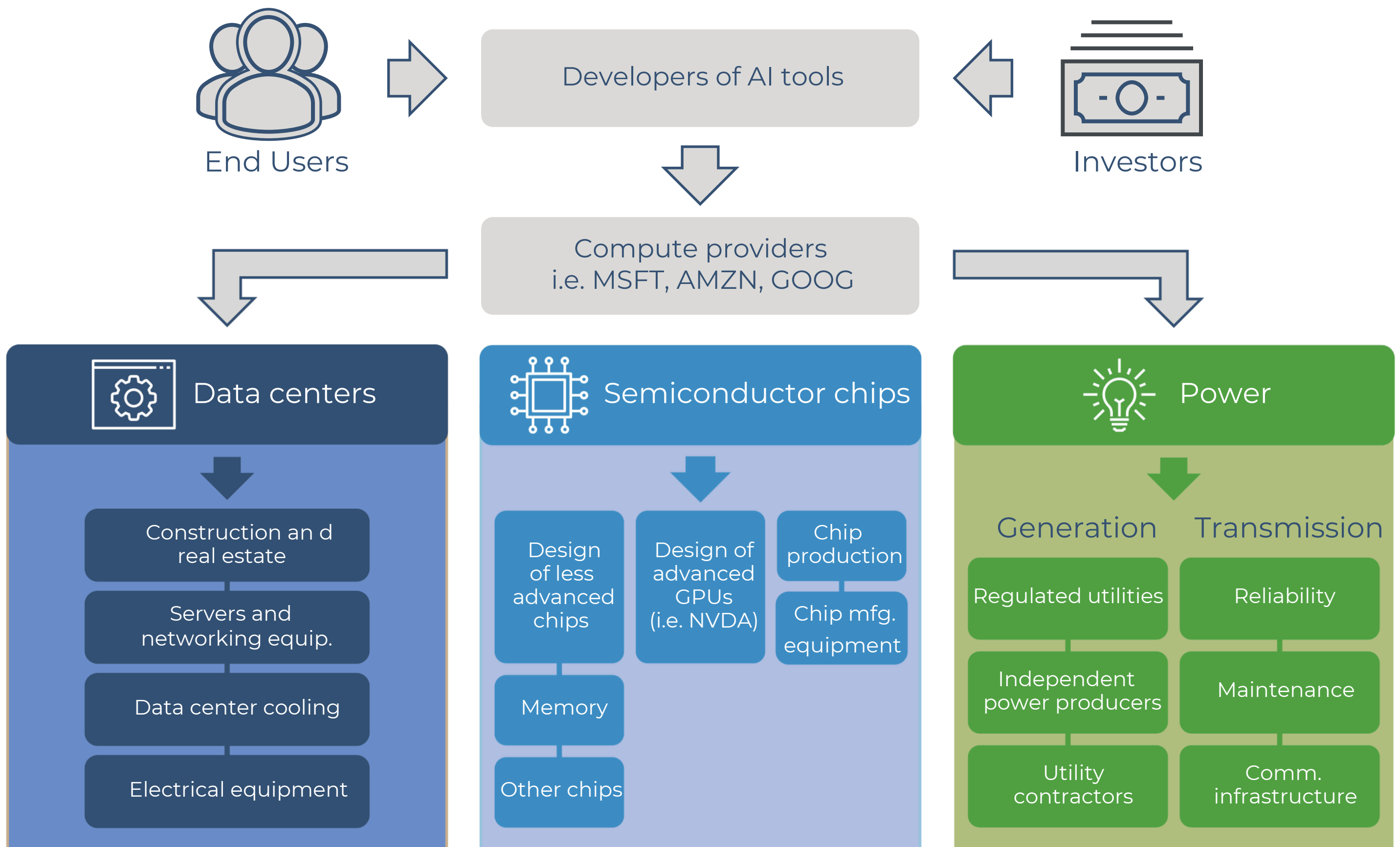


Sources: Bloomberg, Apollo Chief Economist. Data as of June 2024 .

Looking ahead to 2025 and beyond, key drivers for adoption include advancements in chip technology, the democratization of AI tools for small- and medium-sized companies, and government efforts to reshore critical semiconductor manufacturing. Beyond the dominance of the industry leaders, the broader ecosystem supporting AI is just as critical. Companies in other areas such as data center REITs, energy providers, and hardware manufacturers, are well positioned to gain from the growing demand for AI infrastructure.

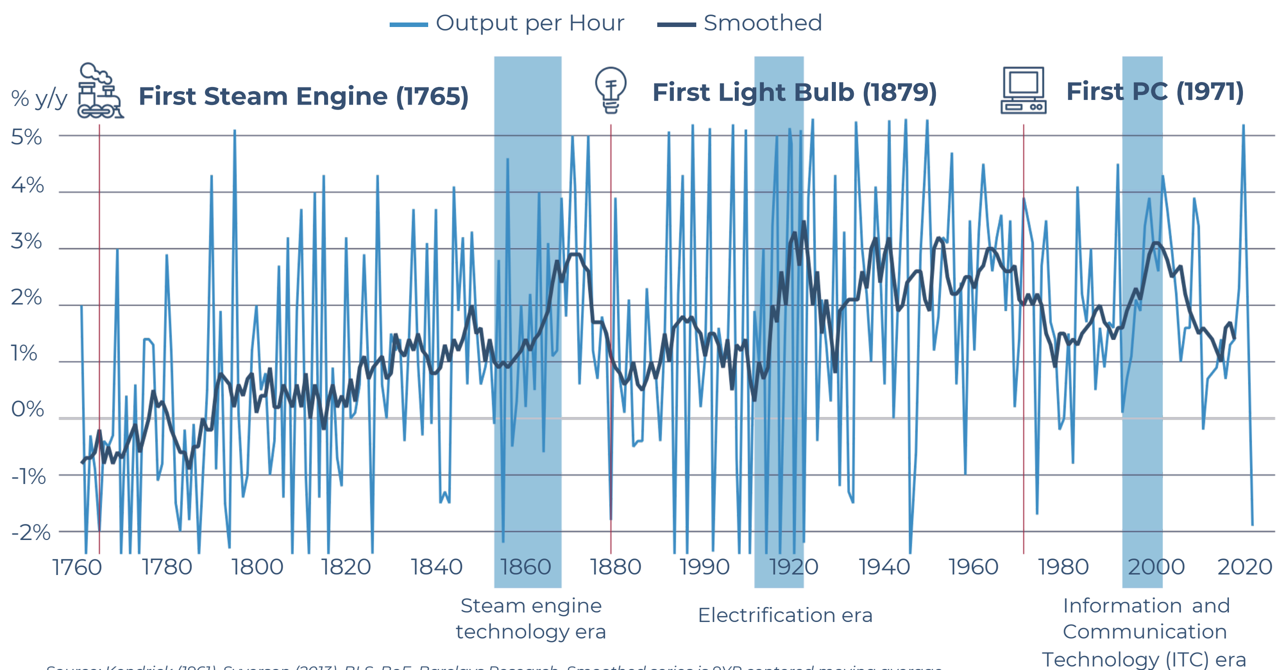
> "Data center REITs, energy providers, and hardware manufacturers, are well positioned to gain from the growing demand for AI infrastructure."

On the real estate front, firms are developing multimegawatt data center campuses, while energy providers are building nuclear-powered campuses to address AI's skyrocketing electricity demands. In healthcare, AI-powered systems are innovating diagnostics, optimizing workflows, and improving patient outcomes. Logistics, too, is undergoing transformation as firms are deploying AI-powered robots to enhance warehouse efficiency, reduce costs, and streamline supply chains. Firm's deploying Generative AI, powered by large language models like ChatGPT, have witnessed historic growth. Released in November 2022, ChatGPT set a record as the fastest application to reach 100 million monthly users in just two days, underscoring the technology's disruptive potential. These advancements demonstrate how AI is becoming a foundational power, reshaping industries, driving innovation, and opening new avenues of growth for the economy in 2025 and beyond.



Source: Bridgewater Associates, J.P. Morgan Asset Management. Data are as of November 15, 2024.

Zooming out, we argue that AI represents not just a technological advancement but a structural shift in the economy, redefining how growth can be achieved. Economists predict that AI could boost U.S. productivity by 1.5% annually, potentially adding 8-9% to GDP over the next decade. Unlike past technological revolutions, such as the steam engine or the personal computer, AI's adoption timeline is expected to be much faster, with its productivity benefits becoming evident in economic data by the late 2020s. By automating labor-intensive tasks, enhancing decision-making, and enabling new economic activities, AI is poised to transform industries and reshape economies.

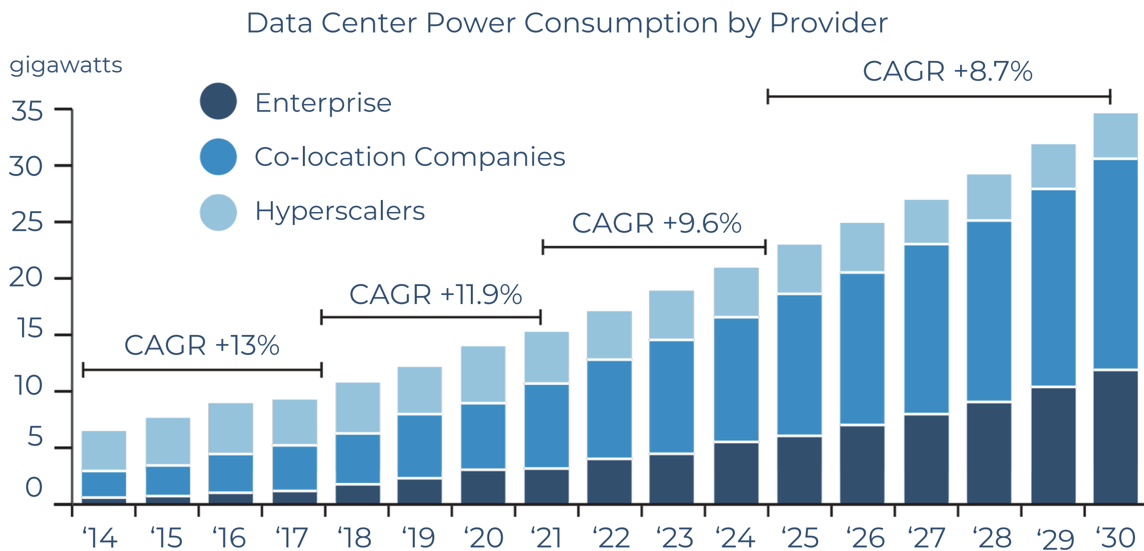


Source: Kendrick (1961), Syverson (2013), BLS, BoE, Barclays Research. Smoothed series is 9YR centered moving average.

However, this transformative power comes with significant challenges that must be addressed to ensure sustainable growth. Workforce disruptions are a major concern, with up to 30% of jobs in advanced economies potentially subject to automation over the next 20 years. White-collar roles, such as technical writing and budget analysis, are particularly vulnerable, highlighting the need for proactive public policies such as job retraining and workforce adaptation programs. This is a modern example of creative destruction – a process where old industries and roles are replaced by new, innovative ones. While the transition may be disruptive, history shows that technological advancements ultimately lead to the creation of entirely new jobs and economic opportunities.

At the same time, AI's growth is under pressure from supply chain bottlenecks and energy demands. China's ban on critical rare metals like gallium and germanium, essential for semiconductor production, poses a major threat to AI infrastructure. This recent move, seen as retaliation for U.S. chip export restrictions, could further disrupt an already fragile supply chain. Adding to the uncertainty, President-elect Donald Trump has floated the idea of new tariffs on Chinese goods, potentially escalating tensions more. Meanwhile, AI's energy needs are expected to soar, with data centers projected to consume 8% of U.S. electricity by 2030, up from just 3% in 2022. Addressing these challenges will require innovative solutions, such as nuclear-powered data campuses and increased integration of renewable energy, to ensure AI's expansion remains sustainable.

AI Data Centers Have Insatiable Demand For Power



Sources: J.P. Morgan Wealth Management, Bloomberg Finance L.P. Data as of Q2 2024.

> "AI's energy needs are expected to soar, with data centers projected to consume 8% of U.S. electricity by 2030."

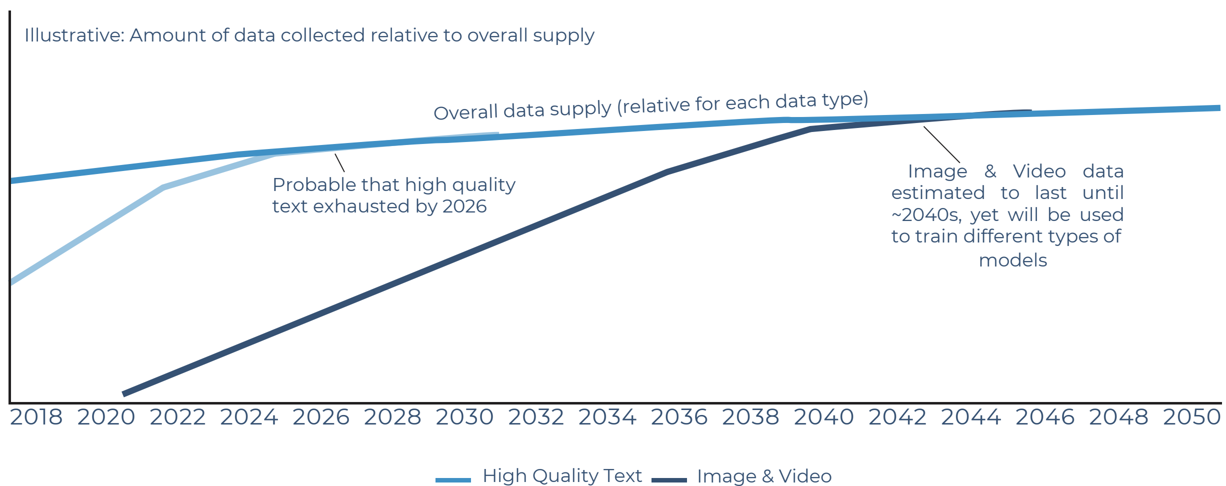
The emergence of Chinese AI startups like DeepSeek could throw a wrench in the AI buildout as it is amplifying concerns for U.S. AI companies and their investors. DeepSeek’s rapid development of a ChatGPT equivalent, achieved despite restrictions on advanced GPUs and at a fraction of the cost, raises significant questions about the sustainability of lofty U.S. AI valuations. If efficient models like DeepSeek's can compete without such staggering investments, it challenges the notion that heavy capex is the optimal approach to leading in AI. For investors betting on the AI theme, DeepSeek serves as a stark reminder of the risks tied to escalating costs and intensifying international competition.

Legal and ethical concerns further complicate the progression of AI’s development. The supply of high-quality human-generated data needed to train AI models is finite and projected to be depleted within the next 15 years. At that point, AI models will rely on synthetic datasets, data created by AI itself, to continue training. This poses risks of “model collapse,” where model quality degrades over time, increasing errors as they progressively rely on artificially generated rather than factual.

> "DeepSeek challenges the notion that heavy capex is the optimal approach to leading in AI."

Data Scarcity is a Potential Wall to Scaling Models

High quality text data could be exhausted soon, images & video have longer runway



Source: Coatue

> "It highlights the need for regulatory oversight to establish effective checks and balances, ensuring that AI develops responsibly and ethically. "

Rather than a speculative bubble, AI represents a multi-year investment cycle with significant long-term potential. AI's integration is set to drive economic growth, enhancing efficiency and generating new opportunities. Early adopters are already enjoying a considerable competitive advantage as improved automation, decision-making, and process optimization drive lower costs and higher efficiency. While challenges like supply chain constraints and energy demands persist, they also pave the way for innovation. In 2025, AI's evolution goes beyond technological advancement, it is about unlocking new pathways for productivity, investment, and economic transformation.

Oh, and in case you're wondering - yes, AI wrote this entire theme. Just kidding, we're not at the point where AI is stealing the writing gigs from us humans... yet.

THE U.S. ECONOMY:

A CYCLE UNLIKE ANY OTHER

The current business cycle is anything but ordinary, diverging significantly from historical norms and shaped by transformative structural shifts. These changes, driven by exogenous shocks and powerful trends, have altered the traditional cyclical trajectory of expansion, peak, contraction, and trough. As we entered last year, many experts predicted a slowdown or even a recession, citing indicators such as weak manufacturing activity, an inverted yield curve, and aggressive monetary tightening. Yet, the U.S. economy defied gravity, exhibiting a rare combination of robust GDP growth and moderating inflation. It begs the question, how were so many economists and forecasters wrong about the direction of the economy?

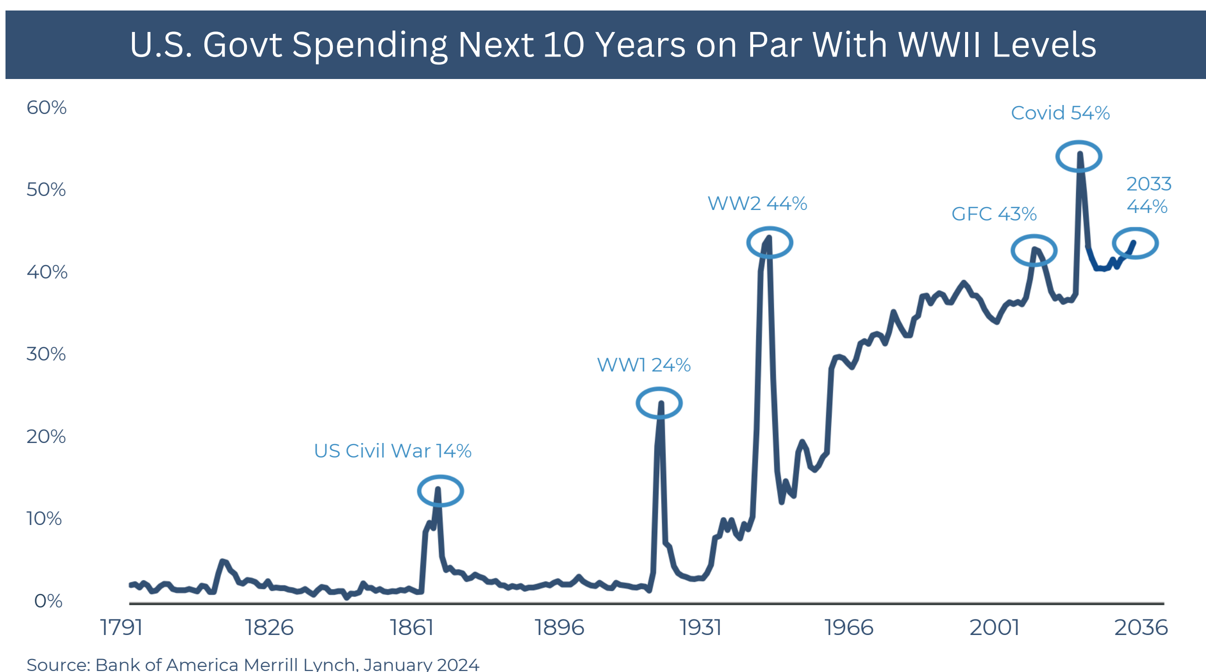
H Heading into 2024, various traditional economic indicators pointed to contraction, leaving many to wonder if their recession calls were not wrong, just premature. The answer lies in the fundamental changes and pivotal policies in recent years that have extended the growth runway beyond traditional expectations. Key themes, such as massive fiscal spending, the explosion of investment in the AI revolution, and a resilient consumer base, have created unique tailwinds that continue to drive the U.S. economy ahead. We anticipate these developments to sustain solid, albeit slower, U.S. growth into 2025, with consumer spending serving as a core driver. While the conventional economic playbook still holds relevance, it may need to step aside to accommodate the forces that are fundamentally reshaping the modern economic landscape.

Source: Waterloo Capital

> "While the conventional economic playbook still holds relevance, it may need to step aside to accommodate the forces that are fundamentally reshaping the modern economic landscape."

Fiscal policy has undergone a notable transformation during this business cycle, with government spending playing a far more active and sustained role than in prior periods. Historically, fiscal interventions during downturns, such as the 2008 financial crisis, focused heavily on stabilizing corporations and financial markets to restore confidence. In contrast, the present cycle has been characterized by direct, targeted expenditure that has benefited both consumers and businesses, profoundly altering the economy.

As a result, government spending as a percentage of GDP has surged, reaching levels not seen since World War II and reflecting the unprecedented scale of modern fiscal intervention. Pandemic-era government transfer payments directly bolstered main street, boosting aggregate demand and enabling consumers to sustain spending far longer than in past cycles.



Source: Bank of America Merrill Lynch, January 2024

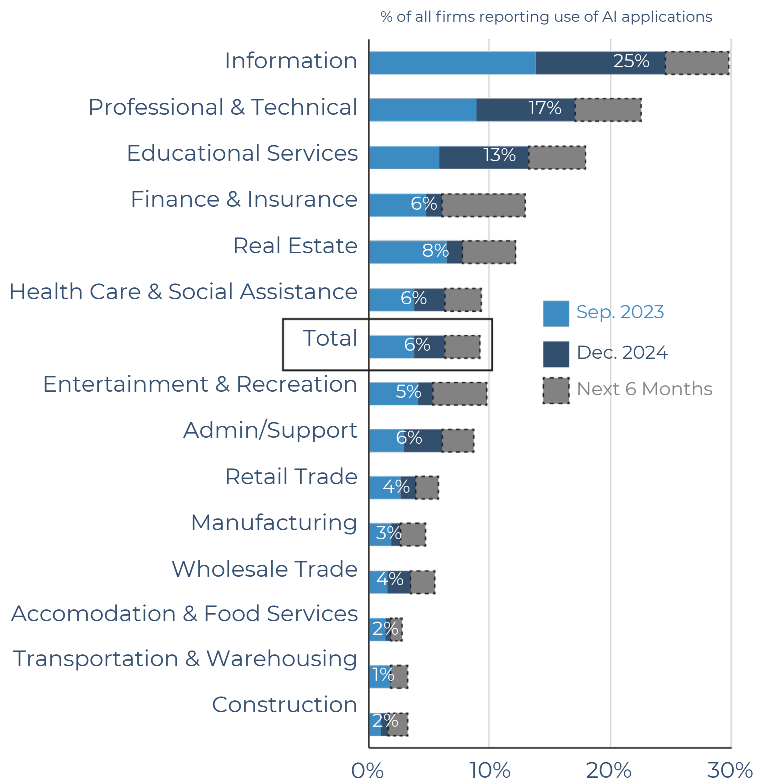
Beyond direct support to consumers, legislative programs have reshaped fiscal policy's role in driving long-term growth. These initiatives reflect a strategic transition toward supply-side fiscal spending, designed to enhance productivity and economic capacity rather than merely stimulate short-term demand. Given this trend, government spending is expected to remain a key contributor to growth in the years ahead. By directly supporting strategic sectors and consumers, fiscal policy has overridden the traditional business cycle's natural slowdown mechanisms. While this approach has fueled a strong recovery and expansion, the growing reliance on government spending raises long-term sustainability concerns, particularly as the U.S. debt-to-GDP ratio climbs.

Building on the growth impacts of fiscal policy, the artificial intelligence boom and scaled adoption of large language models have structurally altered our economy. Not long ago, tools like ChatGPT were viewed as novelties - simple applications for casual use. Today, AI has evolved into a productivity powerhouse, creating strong tailwinds for the U.S economy.

This AI boom has provided a critical shot in the arm at a time when typical economic slowdowns might otherwise have taken hold. Comparisons can be made to the 1995 soft landing, which was marked by a surge in computing power and the widespread adoption of the World Wide Web. This time around, productivity gains are even more pronounced, with applications that seamlessly integrate into everyday tasks rather than being limited to the internet. This convergence of technology and productivity has ignited a new era of exceptional economic growth. Companies are pouring unprecedented levels of capital into AI infrastructure, such as data centers and energy solutions, positioning the U.S. as the epicenter of this technological revolution. This investment is not only enhancing efficiency but aiding innovation and job creation, fueling broader economic activity and offering the U.S. another crack at growth in the business cycle.

> "The A.I. boom has offered the U.S. economy another crack at growth in the business cycle."

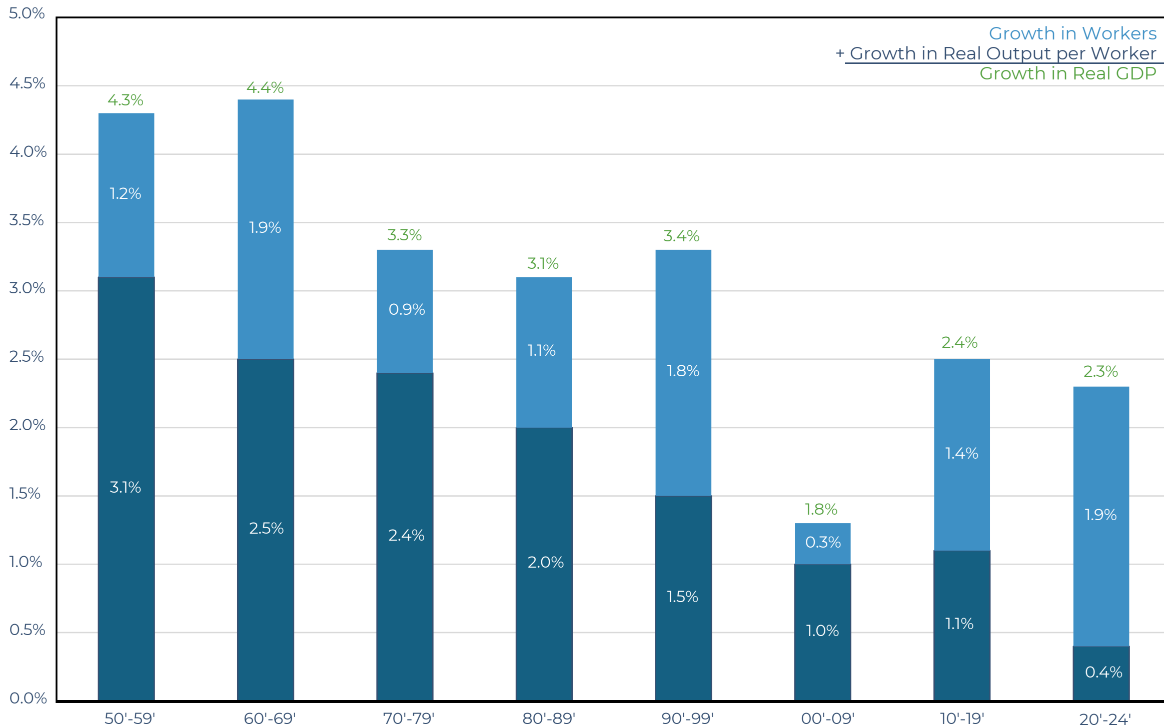
Businesses Using AI to Produce Goods & Services



Source: J.P. Morgan Guide to the Markets. Waterloo Capital

Drivers of GDP Growth

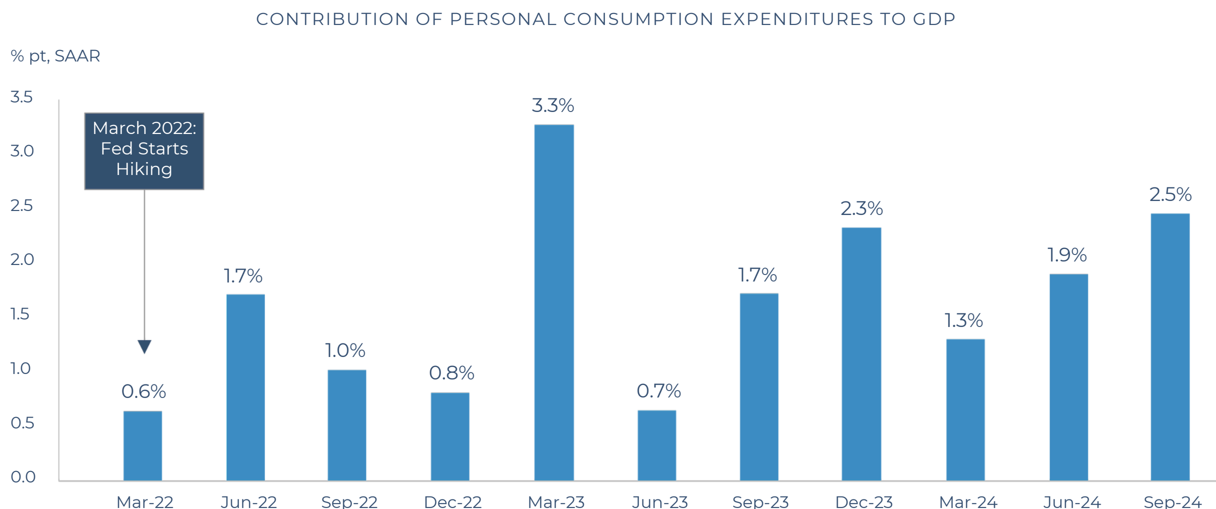
Average year-over-year % change



Source: J.P. Morgan Guide to the Markets. Waterloo Capital

These transformative shifts in fiscal spending and the rise of artificial intelligence may deviate from traditional economic cycle playbooks, but one constant endures: the consumer remains the anchor of U.S economic resilience and growth. Accounting for 68% of GDP, consumer spending expanded at an impressive 3.1% annualized pace as of Q3 2024, though this growth is expected to slow to around 2.0% in 2025. What stands out is the source of this strength, even in the face of higher interest rates, primarily driven by the top income earners, who contribute 40% of total consumption. These households have significantly benefited from rising equity and real estate prices, bolstering their net worth. Equity ownership as a percentage of household net worth is at its highest level since 2000, while credit card debt as a percentage of disposable income remains historically low. Coupled with strong wage growth and a sturdy job market, these factors have fortified the balance sheets of higher-income households, providing a solid foundation for sustained spending into 2025.

The Fed's Hikes Have Not Slowed Down the U.S. Consumer



Sources: BEA, Haver Analytics, Apollo Chief Economist. Data as of September 2024.

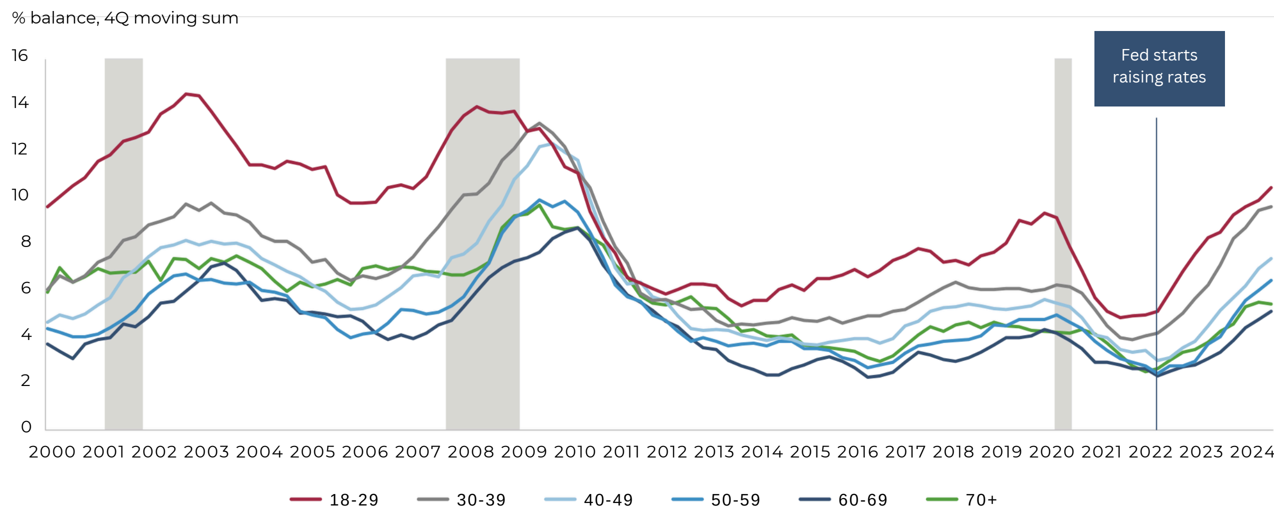
Yet, the disparities among income groups cannot be ignored, as they pose potential threats to sustaining economic growth in 2025. Lower-income households and younger consumers are bearing the brunt of rising interest rates, resulting in increased credit card and auto loan delinquencies. Many of these groups have yet to rebuild their savings to pre-pandemic levels, leaving them more susceptible to economic shocks. These mounting pressures could push the U.S. economy toward a tipping point, where weakened consumer demand jeopardizes its momentum.

Households at the lower end of the income spectrum have also been disproportionately affected by inflation. Recent data showed price pressures intensifying within recent months and complicating the Federal Reserve's path to achieving its 2% target. Over the last four years, cumulative inflation has reached about 23%, significantly eroding purchasing power for much of the population and tightening household budgets. This economic fragility has the potential to create a negative feedback loop: restrained spending could hurt corporate revenues, prompting firms to cut back on hiring or even lay off workers. Such a crack in the labor market would further dampen consumption, amplifying risks to the economy.

> "Consumers have yet to rebuild their savings, leaving them more susceptible to economic shocks."

Younger Households Are Feeling The Pinch In Their Credit Cards...

CREDIT CARD TRANSITIONS TO SERIOUS DELINQUENCY (90+), BY AGE



Sources: New York Fed Consumer Credit Panel/Equifax, Apollo Chief Economist
Data as of June 2024 .

Looking at 2025, there is a lot to digest. In a cycle unlike any other, the U.S. economy has rewritten the rules, defying traditional expectations as an expected waning growth was replaced by remarkable resilience and transformation few anticipated. This newfound strength comes with complexities this year such as rising income disparities, mounting debt, and upside pressure on inflation leave headwinds gathering on the horizon. The story of this extraordinary cycle is still unfolding, and economic resilience may increasingly hinge on the strength of the consumer.

Labor shortages, excessive spending, and widening income disparities risk reigniting inflationary pressures and weakening the broader consumer base - the backbone of economic activity. As the U.S. economy stands at a unique crossroads, there is optimism for growth in 2025. Yet, this cycle has defied the traditional playbook, extending its run against historical norms. While we believe slower growth is inevitable and these trends, that have prolonged our expansion, will not shield the economy forever, we ultimately anticipate they will drive stable growth in the year ahead.

POLICY AND POLITICS:
PLAYING THE TRUMP CARD

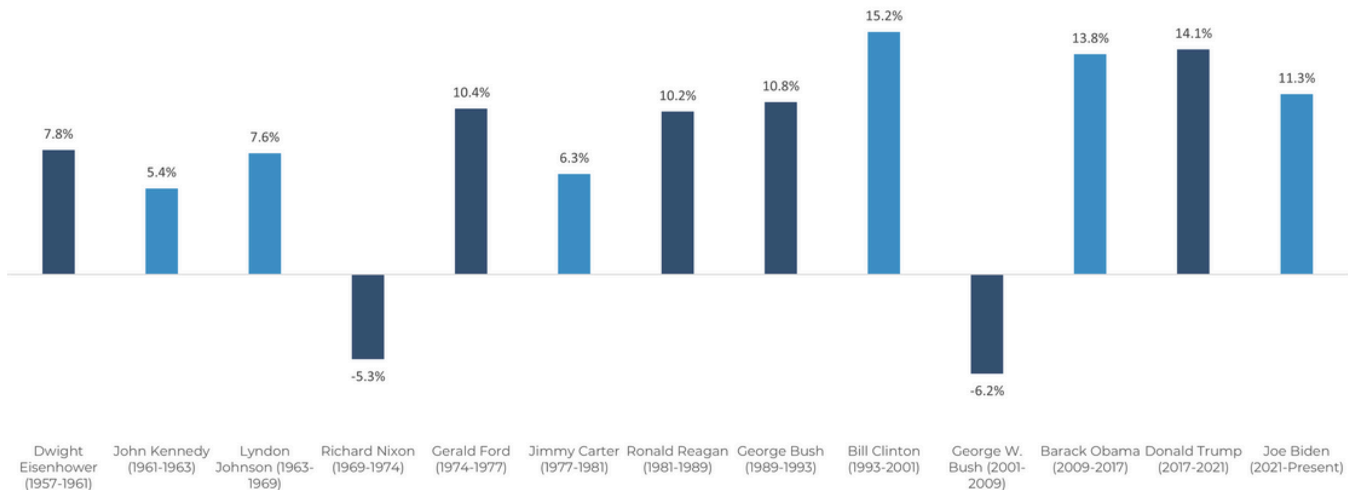
The Republican clean sweep in Washington has set the stage for what many are calling "Trumponomics 2.0." With the deck now stacked in their favor, we're being dealt a new hand of economic policy as focus shifts from the drama of the election's outcome to its impacts. While the timing and scope remain up in the air, we expect a wave of policy moves including potential tax cuts, deregulation, tariffs, and revisions to immigration to ripple through various markets and sectors in 2025.

Markets wasted no time reacting to a decisive Trump victory. The post-election rally reflects not just optimism but, more importantly, clarity. Small caps and financials surged, benefiting from the prospect of industry deregulation and a stronger pro-U.S. growth stance. Fixed Income, on the other hand, took a hit with yields climbing on potential tariff policy and increased projections for fiscal deficits. Although policy posturing garners headlines, action and fundamentals will have the final say in 2025 and beyond.

Additionally, there is no clear correlation between which side of the aisle wins the White House and market outperformance as in either case the market typically responds with gains. This year, uncertainty around what policy shifts will be enacted and when they will come to fruition will generate fatter tails on both sides of the return distribution – suggesting a higher probability of extreme outcomes.

> "Although policy posturing garners headlines, action and fundamentals will have the final say in 2025 and beyond."

S&P Performance: Compound Annual Growth Rate



Source: The White House Historical Association, Ycharts, Bloomberg, Waterloo Capital. Inuguration was used as start and end date for full terms. Joe Biden data as of 12/31/2024

Trump's plan to stimulate economic growth once inaugurated includes tax cuts, expanded deregulation, a pro-U.S. focus, and improving government efficiency.

The Tax Cuts and Jobs Act (TCJA), passed by a Republican-majority Congress in 2017, marked the largest tax code overhaul in decades, but is set to fully expire at the end of 2025. If the TCJA provisions end, Brookings estimates a 1.8% reduction in after-tax income for the average taxpayer, with the top 1% of earners shouldering a 3% cut. On the other hand, the Congressional Budget Office projects that expiration could raise government revenues by $4.6 trillion over the next decade, approximately 1.3% of projected GDP, creating a large inflow for federal coffers. We believe that with both chambers of Congress under Republican control, an extension of most TCJA provisions appears likely towards the end of 2025, even with tight margins. However, certain measures, such as the SALT deduction cap and the reduced corporate tax rate are expected to face significant resistance. The full effects of these tax changes won't be felt until 2026, but if Republicans succeed in securing an extension, we can anticipate another shot in the arm for the American consumer which has consistently driven economic growth and resilience the last few years.

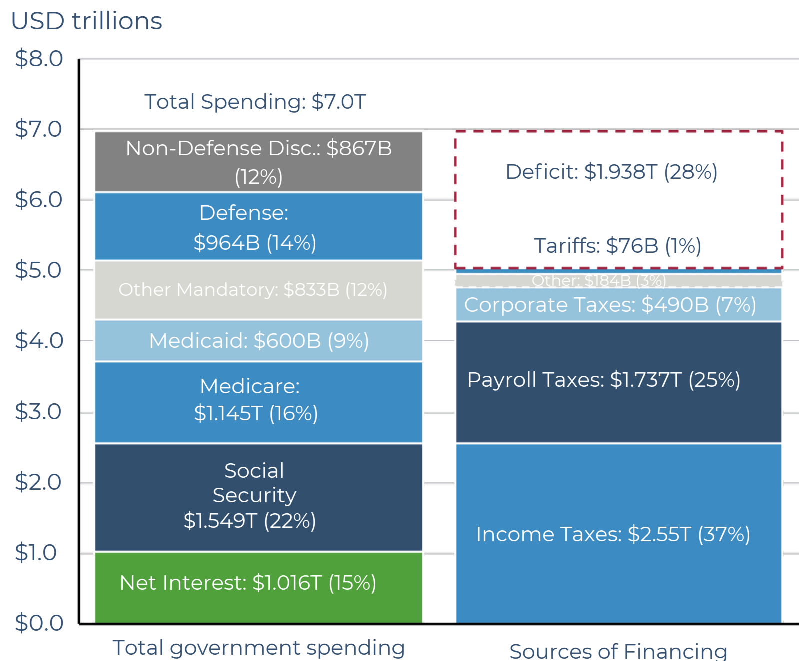
Trump's return to the White House leads us to believe that his administration will revert to the pro-growth, deregulatory agenda that characterized its first term. During that period, eased regulations for banking, fintech, and startups created a more favorable business environment. Such policies, if reprioritized, could benefit sectors like Financials the most. Deregulation's ripple effects will likely spark a resurgence in mergers and acquisitions (M&A) activity, potentially benefiting larger companies searching for targets. The crypto space could also be a benefactor as Trump plans to ramp up investments into digital assets and appointed David Sacks as his "Crypto Czar", seen by many as a bullish sign for the asset class. While deregulation is a powerful catalyst for market opportunities, it isn't a one-size-fits-all solution as the effects will vary significantly across industries and companies.

In an exciting move aimed at addressing the ballooning federal deficit, the Trump administration has introduced an innovative initiative: the Department of Government Efficiency (DOGE). While not a formal federal department, DOGE represents a bold attempt to streamline government spending and cut waste, with the ambitious target of slashing $2 trillion in federal expenditures. At the helm are business giants Elon Musk and Vivek Ramaswamy. The concept behind DOGE is straightforward - create a leaner, more efficient government. Yet, we believe executing this vision will be anything but simple. Unlike traditional government agencies, DOGE will operate independently, acting as a temporary advisory body and disbanding by Summer 2026. Its recommendations will be just that: advice. The real power to implement spending cuts lies with Congress, which must navigate political realities and constitutional constraints.

The biggest challenge?

Tackling the nation’s most significant and politically protected programs. These regarded “untouchable” programs make up over 60% of spending. Additionally, interest payments on our nation’s debt account for another 15%. Achieving meaningful deficit reduction to the tune of their $2 trillion target without addressing these systems would require austerity measures on a scale not seen since the post-World War II era.

The 2025 Federal Budget



Source: J.P. Morgan Guide to the Markets

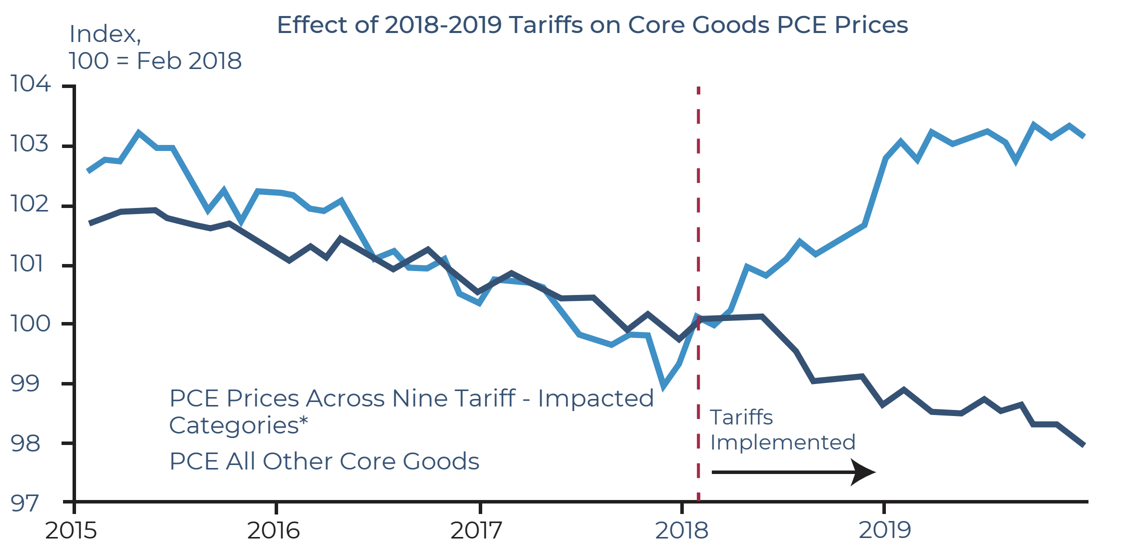
Historically, efforts to reduce government waste have had mixed results, and DOGE’s success hinges on more than ambition. Early discussions have floated potential workarounds to bypass Congressional roadblocks, but these remain

speculative and vulnerable to legal challenge. For now, the initiative has sparked a necessary conversation about shining a light on inefficiencies and fiscal discipline, even if the path to tangible results appears unclear.

The proposed policy measures, unfortunately, can have large trade-offs, hence our positioning that 2025 will be the year of fatter tails. The Trump administration will have a hard time striking a delicate balance as the growth initiatives could have tangible economic consequences.

At the center of this uncertainty is one of the most impactful and divisive policy areas: tariffs. Shortly after the election, Trump announced plans to impose a 25% tariff on all imports from Mexico and Canada, along with an additional 10% tariff on goods from China. This is the Trump Administration's pitch to ensure an "America First" agenda, theoretically increasing US based firm's share of the domestic marketplace. But the ripple effects are hard to ignore. For many domestic producers, imports are vital as manufacturing inputs. Slapping higher tariffs on these goods raises production costs, which often trickle down to consumers in the form of higher prices. If history is any guide, the lessons of the 2018 trade war under "Trumponomics 1.0" suggest that such tariffs could quickly put upward pressure on inflation in certain categories, eroding purchasing power and complicating growth prospects.

Tariffs Boosted Consumer Prices During the Last Trade War



*Includes laundry equip. & other appliances, furniture, bedding & floor coverings, autoparts, motorcycles & sport vehicles, housekeeping supplies, sewing equipment, and materials. Items are weighted by relative importance to headline index.

Source: Haver Analytics, Goldman Sachs Global Investment Research

Retaliation from key trade partners could deepen tensions, creating a substantial drag on global trade and growth. For now, and into the first half of the new year, we see many of these tariff threats, as real as they are, more posturing than policy. A calculated negotiating tactic with limited immediate bite. If the administration refrains from escalating these measures into a full-blown trade war, the pro-growth effects of other Trump policies, such as deregulation and tax incentives, could outweigh the negatives of tariffs. Still, the stakes are high, and this downside risk is being underpriced by markets. Investors should prepare for volatility, as the tug-of-war between policy intentions and their potential consequences plays out.

> "We see many of these tariff threats, as real as they are, as more posturing than policy."

Adding to the uncertainty are talks of immigration reform. The president-elect has said he will declare illegal immigration a national emergency. He has also vowed to end birthright citizenship, which will likely face legal challenges. His new choice for border Czar, Tom Homan, has said that Congress should provide major funding increases for immigration enforcement.

These developments leave many questions unanswered:

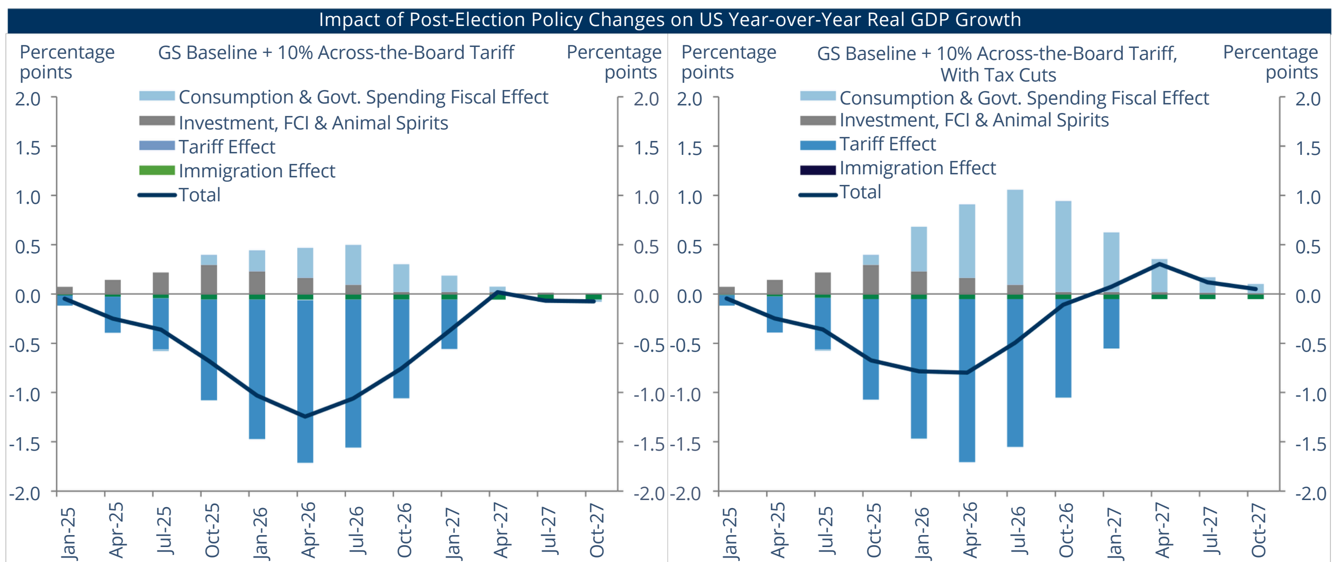
How extensive will these policies be?

Who will they affect?

And most importantly, what will be the economic ramifications?

Undocumented immigrants play a large role in the U.S. economy, with Pew Research recently estimated 8.3 million undocumented workers in the labor force, accounting for 4.8% of all U.S. workers. A sharp reduction in the workforce would likely disrupt labor markets, slow GDP growth, and create inflationary pressures. Additionally, the potential lost tax revenues would deepen fiscal deficits, compounding challenges for government budgets. The scale and specifics of the policies remain extremely foggy, yet it is reasonable to assume that if the Trump administration implements a sweeping and indiscriminate approach, it will undeniably reshape the economy.

Tariffs Outside of Baseline Could Cause a Growth Shock



Source: Goldman Sachs Global Investment Research

As we look ahead to 2025, the new administration may be met with initial optimism and animal spirits, but it's important to keep an eye on the bigger picture. Markets will likely be in for a ride on the volatility rollercoaster as each policy decision, from tax cuts to tariffs to immigration, sparks debate and ripples through the economy. While some measures may deliver short-term wins, they come with significant trade-offs: rising deficits, inflationary pressures, and potential slowdowns in growth. It's important to recognize that these outcomes are a mixed bag for GDP growth as some policies may be stimulative, while others could prove restrictive. However, the common thread is the upward pressure they place on inflation.

Given this dynamic, we believe rates are likely to stay elevated for longer as this brings about a new risk to Federal Reserve policy, potentially handcuffing them in their fight against inflation.

Beyond the shiny promises of new policies also lies a structural problem that has outlasted any single administration since the turn of the century: an addiction to debt-fueled spending. This is a bipartisan reality. For years, both sides of the aisle have contributed to ballooning deficits, kicking the can down the road and increasing long term risks we can't afford to ignore. This problem will continue to undermine fiscal sustainability, putting additional upward pressure on interest rates as borrowing costs increase. The slow burning, but critical issue, should stay in the back of investors' minds in 2025 and beyond as it will define the years to come.

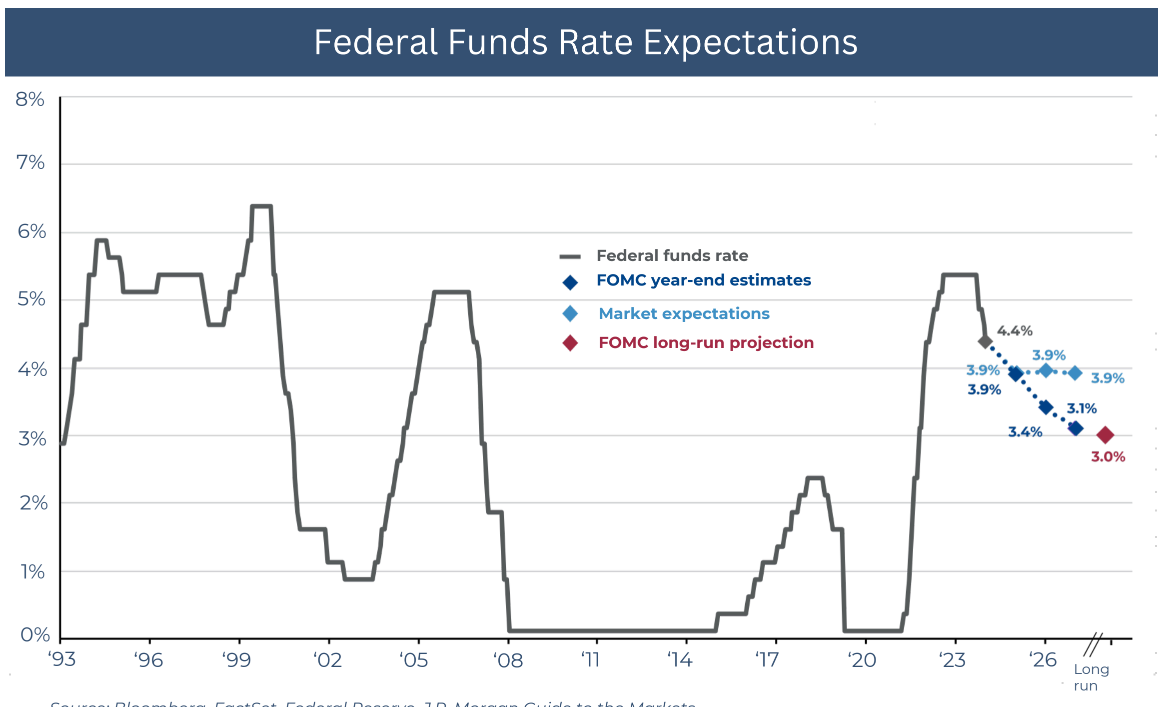
"For years, both sides of the aisle have contributed to ballooning deficits, kicking the can down the road and increasing long term risks we can't afford to ignore."

THE FED'S GHOST: ITS HUNT FOR NEUTRAL

In the dimly lit corridors of monetary policy, the Federal Reserve is chasing a ghost - the elusive "neutral rate" of interest, or r*. The phantom benchmark, where policy neither stimulates nor restricts growth, remains an ever-fleeting mystery. Despite guiding the economy to a soft landing, the Fed's war is far from won. Even with rates at supposedly restrictive levels, clear evidence of their impact is puzzlingly absent, raising questions about future policy action. Is the Fed on the brink of mastering this elusive economic specter, or will the hunt leave it grappling with unintended consequences as inflationary pressures creep back into focus? The answers will define the year ahead.

Against the odds, the Federal Reserve engineered what most market forecasters believed improbable - a soft landing for the U.S. economy. It has steered the highest inflation seen in decades into a manageable range without tipping the economy into recession, following a rate-hiking cycle that raised the policy rate from 0.25% to 5.50%.

Stepping into 2025, both sides of the Fed's dual mandate, full employment and stable prices, are on relatively solid though not perfect footing. The Consumer Price Index (CPI), a key measure of price stability, has climbed to 2.9% in recent months. This level is a significant improvement from the highs of 2022, yet the data remains firmly above the Fed's 2% inflation target. Getting to that target is likely to be more challenging than anticipated as resilient economic growth and persistent shelter inflation continues to hinder further progress. The other side of the mandate remains robust with the labor market posting a healthy string of job gains and an unemployment rate sitting at 4.1%. The Fed's 1.00% of rate cuts since September reflected an impulse to support employment in the event of a slowdown after progress on inflation provided leeway to do so. The focus now turns to what lies ahead for this year.



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Guide to the Markets

> "Recently Fed member's shifted stance, migrating closer to our view that no rate cuts will materialize next year."

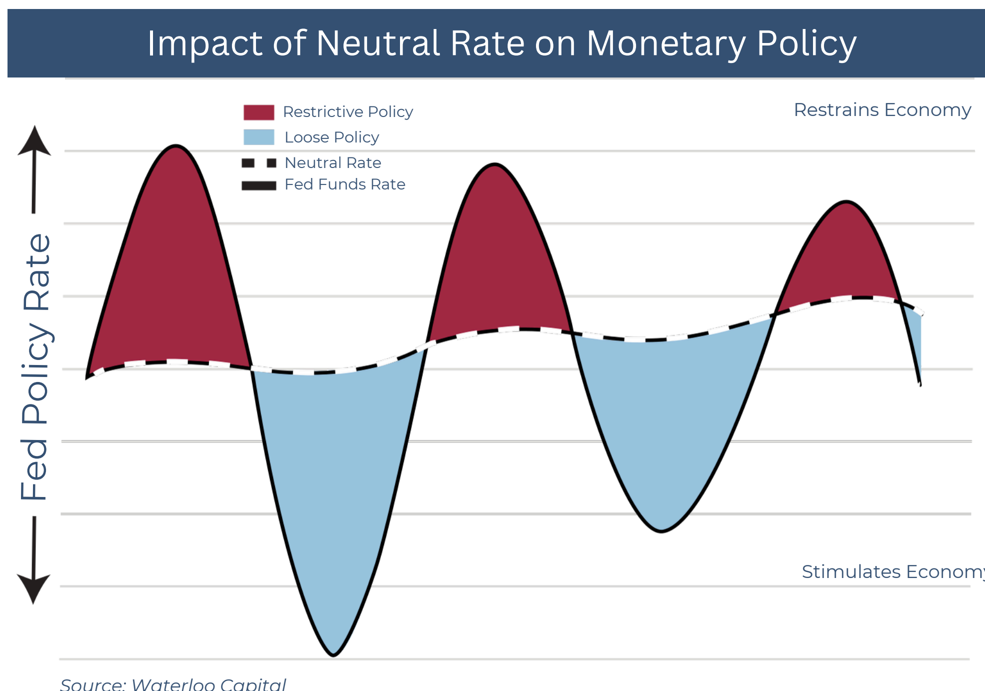
We have long held that the committee's monetary policy projections for 2025 were overly dovish, anticipating too many rate cuts. Recently Fed members shifted stance, bringing their expectations for less policy action in line with market pricing and migrating closer to our view that no rate cuts will materialize next year. At the December FOMC meeting, the central bank slashed their projections for rate cuts in half, anticipating just two this year. Additionally, they elevated their estimates for year-end inflation and GDP growth while lowering their forecasted unemployment rate. These updated projections clearly signal that Powell and his colleagues have a growing concern about upside risks to inflation in 2025.

Despite these higher expectations for both growth and inflation, they still cut rates in December, a puzzling decision. The explanation likely lies in their belief that policy remains "meaningfully restrictive on the economy" and well beyond what they estimate to be the "neutral level". However, the Fed's pursuit of this so-called neutral rate of interest, or r*, is like chasing a ghost. It's immeasurable, ever-changing, and impossible to pin down.

"However, the Fed's pursuit of this so-called neutral rate of interest, or r*, is like chasing a ghost. It's immeasurable, ever-changing, and impossible to pin down."

The neutral rate represents the "Goldilocks Zone" for monetary policy, where growth is neither restricted nor stimulated. This crucial benchmark is not static. It shifts over time in response to structural changes in the global economy and increasing evidence suggests that it has risen higher than previously thought. If that is indeed the case, the impact of today's elevated rate regime may not be as restrictive on business activity as it appears. This shift raises questions about how much easing, if any, is necessary heading into 2025 and beyond.

Impact of Neutral Rate on Monetary Policy



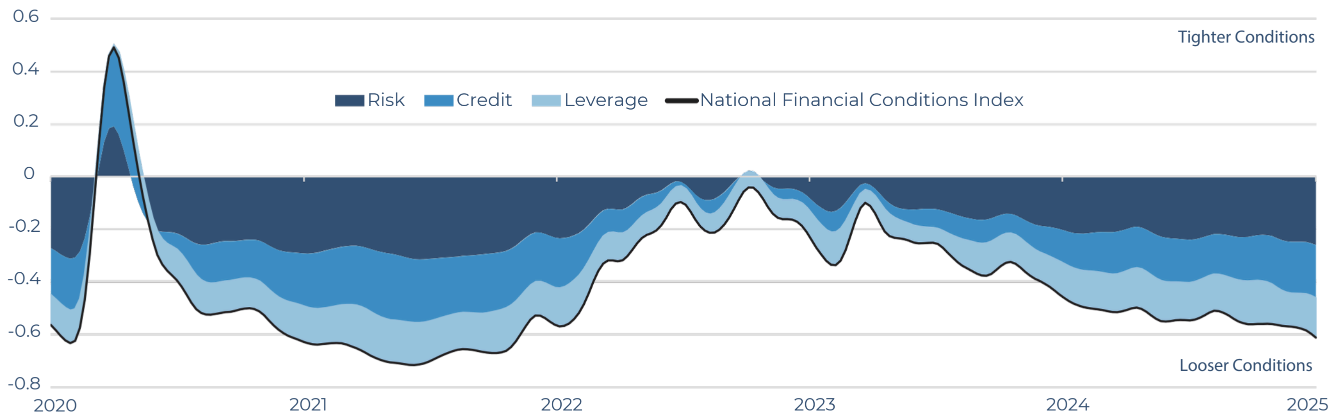
Source: Waterloo Capital

It's our belief in the rise of r* has been driven by a unique mix of forces reshaping the overall economy. The recent push for onshoring has spurred U.S. investment, while breakthroughs in AI are boosting productivity and fueling growth. Combined with stronger-than-expected economic data and persistent global deficits, these forces all point to a higher neutral rate. While r* remains elusive, more ghost than number, experts have refined their models to estimate it, with academics and investment professionals suggesting it could be as high as 4%. Such elevated readings are unprecedented in recent business cycles, leading to the true restrictive impact of current policy being less intense than predicted.

A telling sign that the Fed's monetary firepower has lost some of its potency lies in the state of financial conditions. Traditionally when the Fed raises rates, borrowing becomes more costly for consumers and businesses, tightening financial conditions and cooling economic activity. This effect should be hard to miss, yet despite the Fed funds rate sitting at a widely deemed restrictive rate of 4.25%–4.50%, financial conditions tell a different story.

"A telling sign that the Fed's monetary firepower has lost some of its potency lies in the state of financial conditions."

Financial Conditions Comparable to Levels Seen Before Fed Rate Hikes Began



Source: Federal Reserve Bank of Chicago. Data as of 01/03/2025

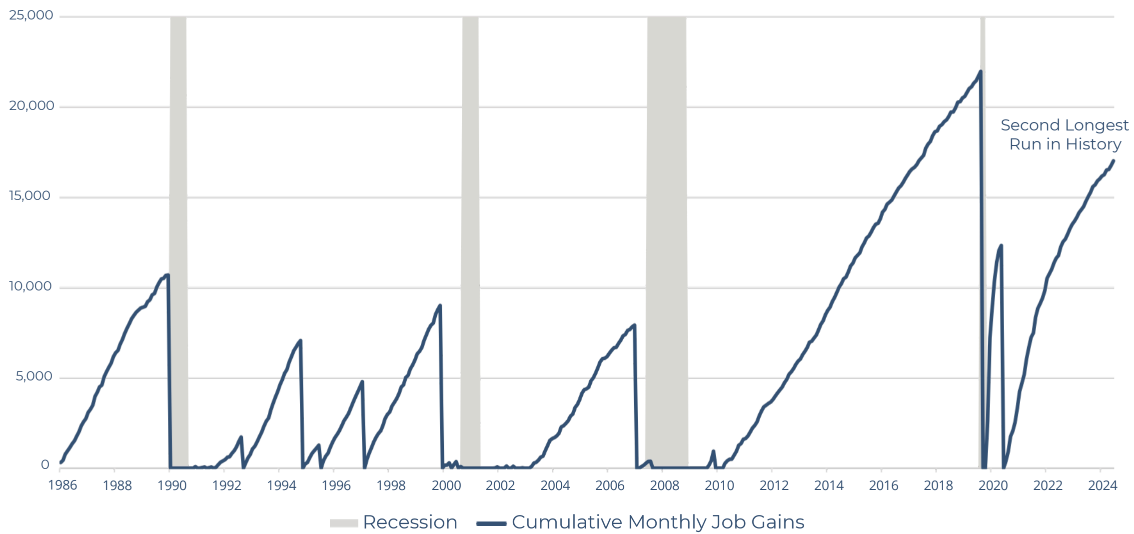
Rather than signaling significant restraint, conditions have remained loose, implying the economy has adapted to higher rates with relative ease. Despite some tightening along the way, conditions entering 2025 are nearly as accommodative as they were before the hiking cycle began in 2022. This raises a critical inquiry about the effectiveness of current monetary policy and indicates it has not been as restrictive as anticipated. While a higher r* plays a role, the massive fiscal stimulus from COVID response measures and other ongoing public policy actions has damped the impact of higher rates. With trillions of dollars pumped into the economy, the Fed faces a complex challenge in navigating persistently loose conditions, relying on the fed funds rate as its primary policy tool. Future policy decisions must account for these fiscal dynamics and the evidence of a higher r*.

> "A strong consumer and resilient economy further reinforce the case for the Fed to forgo rate cuts this year"

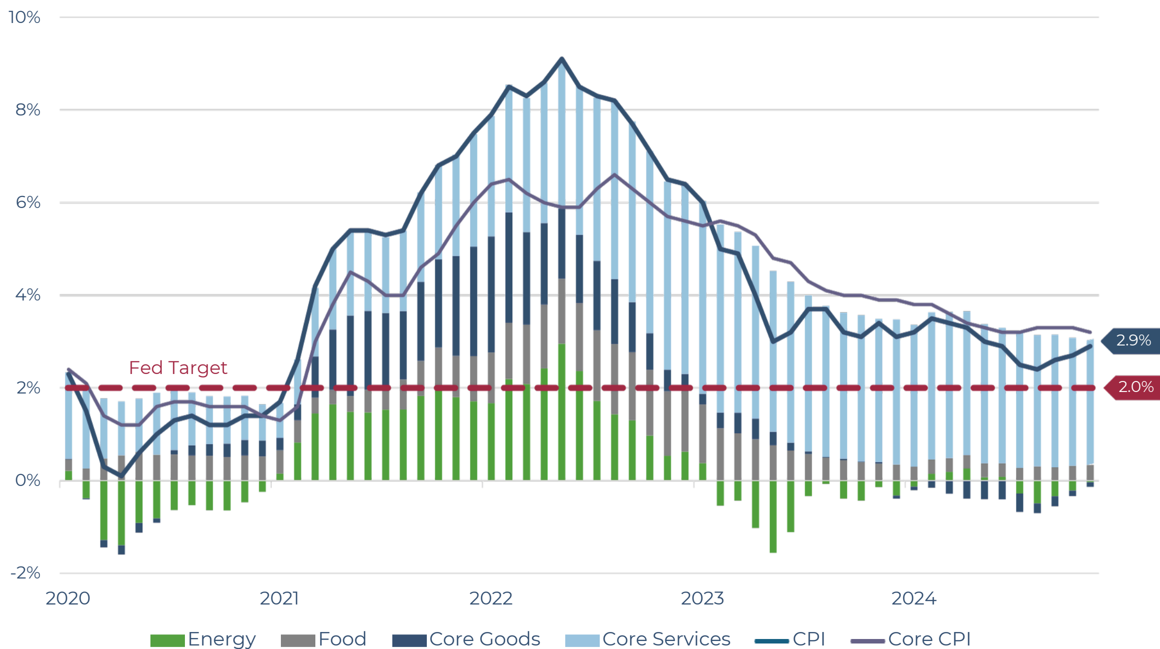
2025 presents a challenging balancing act for policymakers. Loose financial conditions risk undermining progress on bringing inflation back to 2.5%, let alone their target, a dynamic that rate cuts would only exacerbate. A strong consumer and resilient economy further reinforce the case for the Fed to forgo rate cuts this year. Complicating this is the potential for new policies under a Trump-led White House and a Republican Congress to place additional upward pressure on inflation.

A pro-U.S. growth administration and proposals like tariffs, reduced immigration, and tax cuts would almost certainly produce inflationary tailwinds, heightening the risk of reacceleration. In this scenario, fiscal actions could handcuff Powell & Co., forcing them to juggle elevated inflation risks with a diminished tool for doing so.

The Stage is Set for Fed to Forgo Cuts in 2025



Source: Bloomberg, Waterloo Capital



Source: Bloomberg, Waterloo Capital. Data as of 12/31/2024

While the Fed's elusive ghost may be hard to pinpoint, the evidence points to a higher r* than previously assumed. The economy remains remarkably resilient and financial conditions are loose, even with interest rates at relatively high levels - challenging the Fed's claim that current rates are truly "meaningfully restrictive." Barring a sharp labor market deterioration, a higher r* coupled with today's economic and political realities sets the stage for the Fed to hold off on rate cuts in 2025. Further cuts in this environment risk compromising their mandate of price stability, potentially reigniting upside pressures on inflation. In short, the Fed has caught up, but the perceived path forward leaves little room for loosening policy.

"Further cuts in this environment risk compromising their mandate of price stability, potentially reigniting upside pressures on inflation."

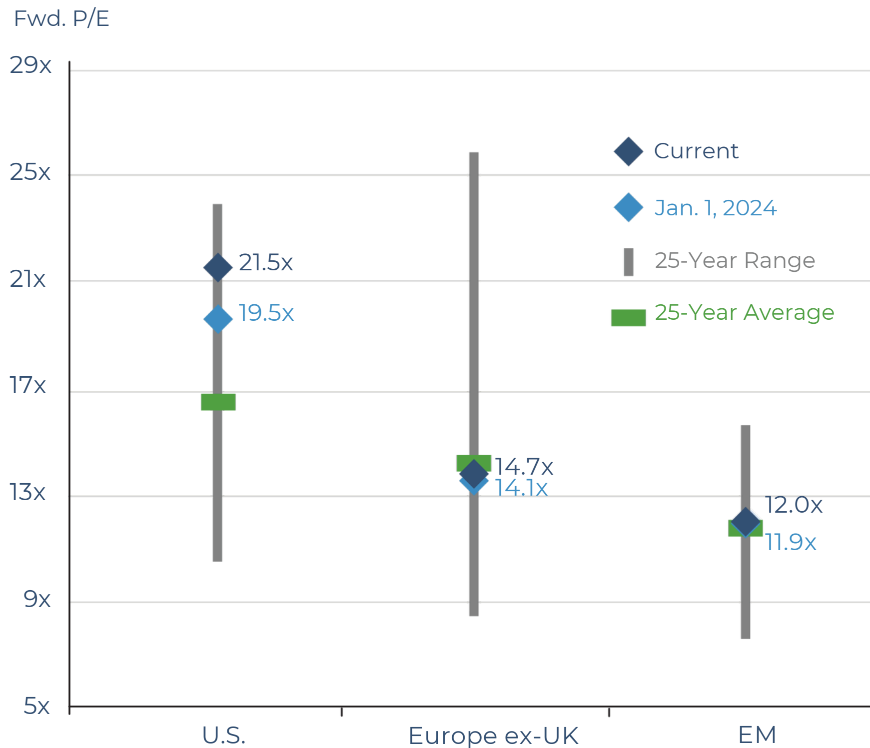
CAPTAIN AMERICA:
U.S. EXCEPTIONALISM

The familiar narrative of foreign markets poised to outshine the U.S. has once again emerged, Yet, time and again, America's markets have proven these expectations wrong. Fueled by relentless innovation, world dominating companies, and an unparalleled ecosystem for success, the U.S. continues to set the standard for resilience and growth. Amid global challenges, the U.S. remains the steadiest and most powerful vessel in rough waters, providing stability, opportunity, and leadership in an unpredictable international market.

What drives this enduring exceptionalism, and will the U.S. once again defy expectations next year?

As we head into 2025, the valuation gap suggests an opportunity for foreign markets to outperform the U.S., on paper.

Global Valuations

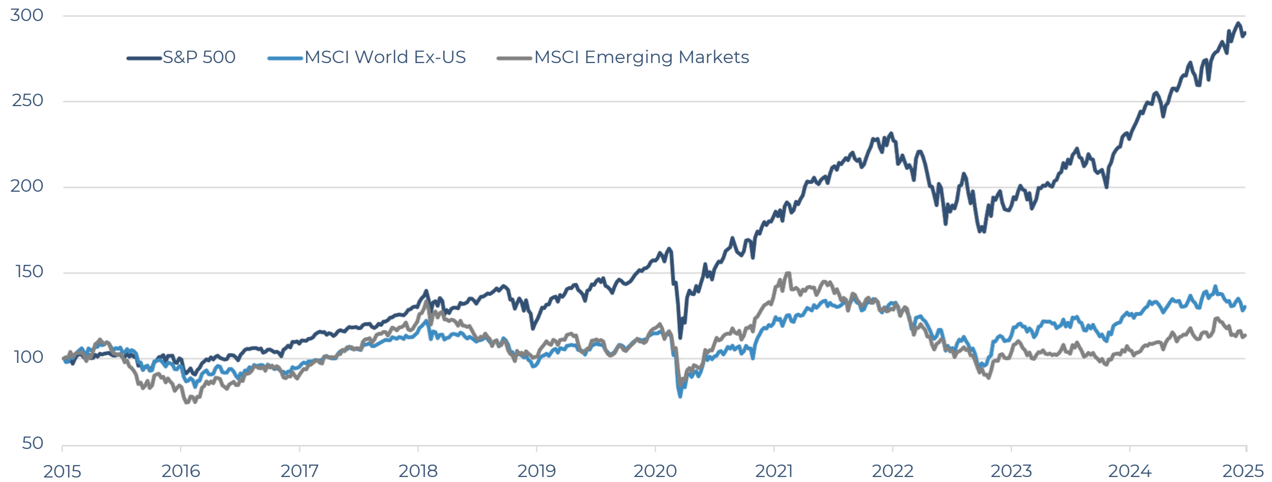


Source: JPM Guide to the Markets. P/E on 12-month forward earnings. Green bar for EM shows 20-year average due to lack of data. As of 12/31/2024

But looks can be deceiving, and the reality has been starkly different. While strategists across Wall Street have long advocated for holding a meaningful allocation to foreign and emerging markets as a portfolio diversifier, the outcomes have fallen short of expectations. Instead of reducing risk or enhancing returns, foreign exposure has often acted as a "de-worsifier," weighing on portfolio performance. Over the past decade, domestic markets have outpaced their international counterparts in eight out of ten years.

"Instead of reducing risk or enhancing returns, foreign exposure has often acted as a "de-worsifier," weighing on portfolio performance."

Index Performance Over the Last Decade



Source: Bloomberg. Waterloo Capital. Data as of 12/27/2024

It's a reminder that while valuations serve as a useful starting point for investing, they are far from reliable timing indicators. The underperformance of foreign equities highlights the importance of assessing not just relative valuations, but also factors like economic growth, currency trends, investor sentiment and their effects on companies. Next year, we are again stacking our chips on the U.S. side of the proverbial table, expecting another year of outperformance versus its foreign counterparts.

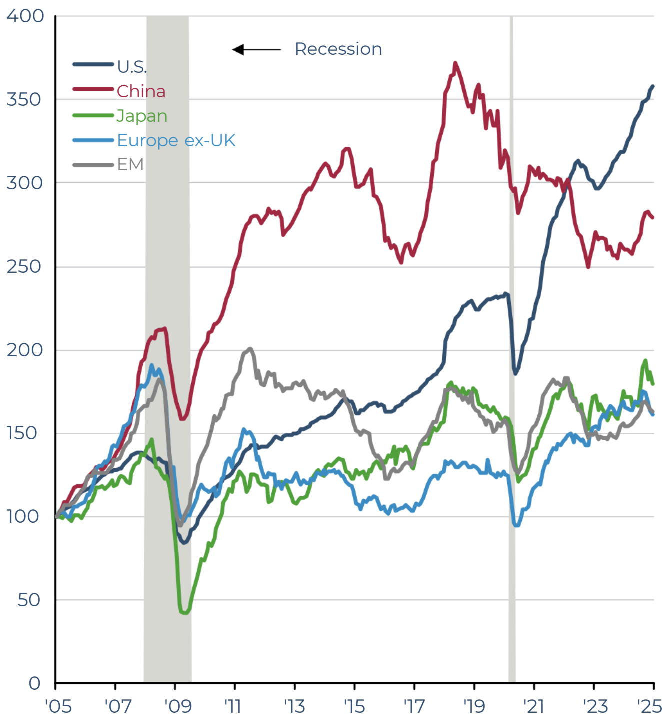
A key contributor to this outperformance, and why it might persist, lies in the structure of different markets. The U.S. stands out as the home of an outsized number of innovative, market-leading companies, and the disparity is striking. Seventeen of the world's largest twenty companies are based in the U.S., many of them technological giants leading advancement in their competitive fields. These firms are among the most efficiently run, boasting healthier margins, stronger profitability, and superior operational efficiency. Adding to this advantage is that present equity indexes, most of which are capitalization-weighted, amplify the impact of these dominant companies on market performance. This structural composition stacks the cards in the U.S. market's favor, creating an environment where the highest concentration of financially successful companies in the world can drive its outperformance.

> "We are again stacking our chips on the U.S. side of the proverbial table, expecting another year of outperformance versus its foreign counterparts."

This concentration is no coincidence and, more importantly, has staying power in 2025. The United States has built a uniquely supportive ecosystem that fosters innovation at an unparalleled scale. Innovation hubs like Silicon Valley not only serve as launchpads for groundbreaking ideas but also as breeding grounds for companies to mature into global leaders. The large talent network, supportive economic policies, and a culture that rewards ambition creates an environment in the U.S. where innovation isn't just encouraged, it's fundamental. This goes somewhat counter to many other parts of the world where stricter regulations, less dynamic policies, and differences in cultural attitudes can hinder the ability of even highly skilled and ambitious professionals to build dominant, lasting companies.

Global Earnings Estimates

Jan. 2005 = 100, next 12 months consensus estimates, U.S. dollars



Source: JP Morgan Guide to the Markets, FactSet, MSCI, Standard & Poor's.

> "In the U.S. innovation isn't just encouraged, it's fundamental."

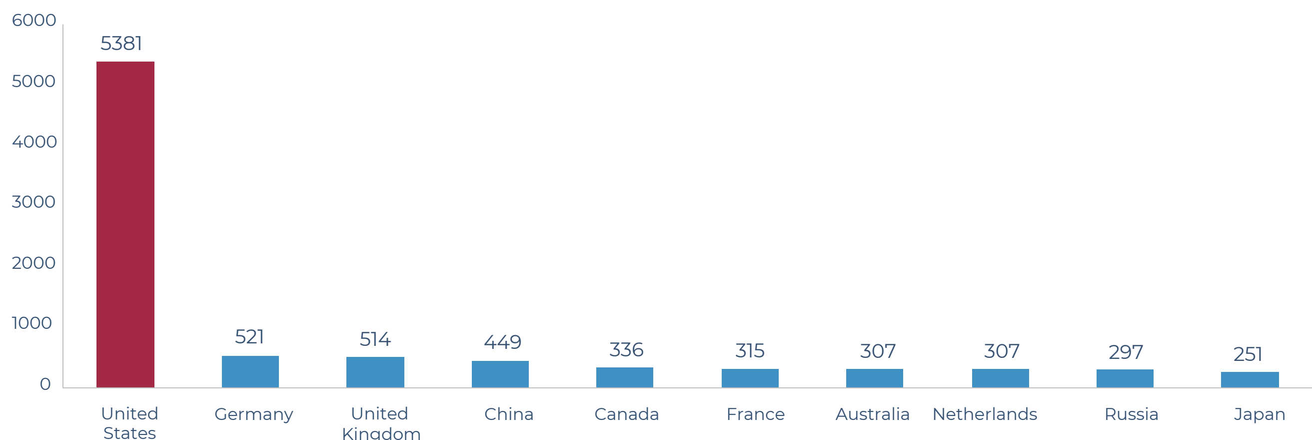
Migration of talent is a critical piece of this puzzle. Although innovative and driven workers originate across the globe, the U.S. consistently attracts these individuals with the promise of prestigious educational opportunities, higher probability of success, elevated financial potential, and even lower tax burdens in many cases. This creates a virtuous cycle: the inflow of skilled labor fuels innovation within the U.S., which further enhances its appeal to global talent. Meanwhile, countries that are unable to foster this ecosystem face a more uphill path to dominate the competitive global market on the same scale. We believe this dynamic will sustain the U.S.'s competitive edge and drive market outperformance for another year.

With artificial intelligence (AI) rapidly emerging as a transformative force, this cycle might be even more resilient. Beyond attracting global talent, the U.S. stands out as the undeniable center of the AI revolution, contributing significantly to the outperformance of domestic markets. Unlike many other parts of the world, the U.S. private and public sectors have been extremely helpful of this new frontier. Policies like the Chips Act and Inflation Reduction Act illustrate this support and provide strong advantages for innovation to flourish domestically.

"The U.S. boasts more data centers than all other major countries combined."

The gap is striking. As of early 2024, the U.S. boasts more data centers than all other major countries combined. These facilities, housing the advanced computing infrastructure necessary for AI, cloud computing, and real-time analytics, are critical to driving breakthroughs across industries. This structural edge accelerates innovation and enhances productivity on an unmatched global scale. Such advantages are poised to translate into stronger relative investment returns in the coming year, as domestic markets benefit from the compounding effects of AI-driven innovation and productivity gains.

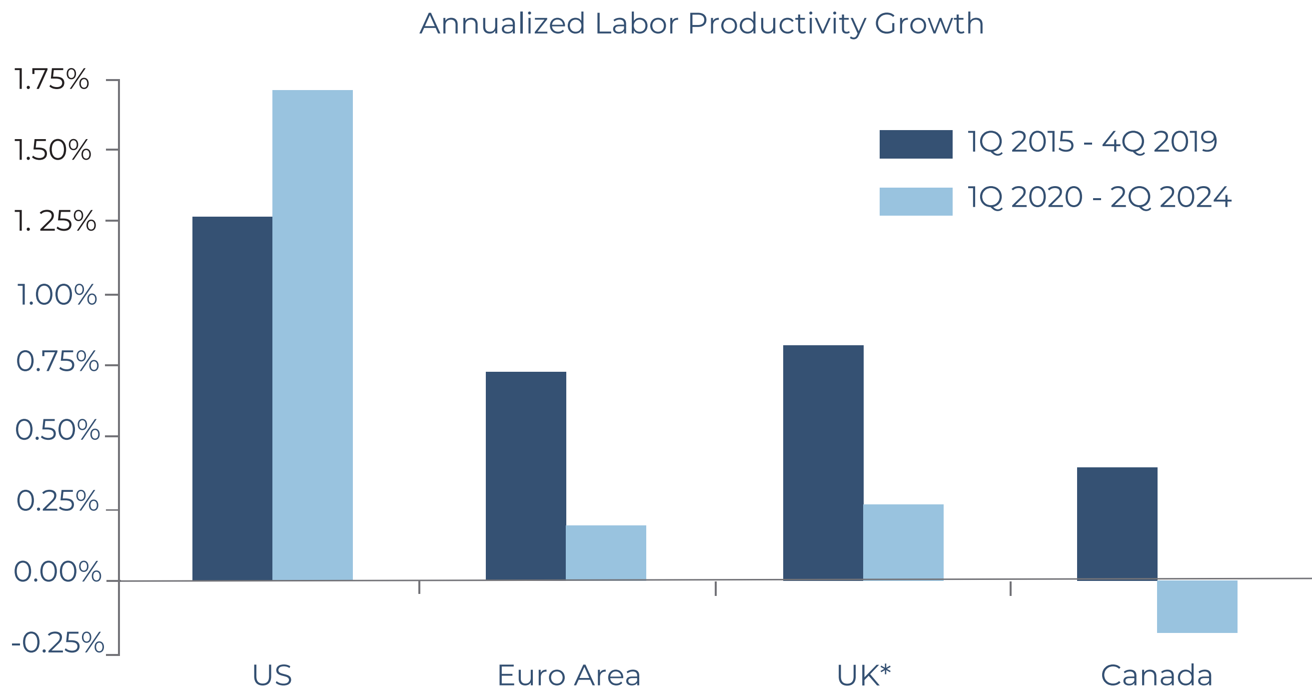
No One Even Comes Close to the United States



Source: Statista , Cloudscene, Apollo Chief Economist. Data as of March 2024.

The ultimate result of these perennial and emerging trends is driving a clear divergence in productivity growth between the U.S. and its global counterparts. Technological innovation, a skilled workforce, and a pro-business environment all elevate productivity within a given economy. The U.S.'s position in these domains translates into higher economic output, stronger growth, and – most critically for investors - greater earnings growth. Historically domestic earnings growth has consistently outpaced most international markets. With structural shifts like AI advancements and talent migration adding further momentum, this outperformance is poised to persist.

Productivity Growth Has Outperformed in the US, Underperformed Elsewhere



Source: Haver Analytics, Goldman Sachs Global Investment Research.
*Labor productivity is defined as total-economy real value-added per hour worked. *UK Q2 2024 is GS Forecast*

We expect the incoming Trump administration to provide some tailwinds for U.S. outperformance, however, the headwinds it poses for other parts of the world are more intense. Markets outside of the U.S. are particularly vulnerable to the large spanning effects of potential hostile trade policies between the U.S. and China. These policies not only damage foreign companies' competitive positions, but also create structural hurdles to their growth. Proposed tariffs from President Trump would place intense pressure on foreign firms' ability to compete in the U.S., but the real punch comes from how these U.S.-first policies strengthen the dollar. A stronger U.S. dollar leads to higher import costs and places downward pressure on the value of global and emerging market currencies.

To make matters worse, foreign markets' economic proximity to rising geopolitical tensions via the escalation of both trade and hot wars adds to the potential headwinds in 2025. These factors elevate risks for the profitability and competitiveness of ex-U.S. firms in the global marketplace, reinforcing the likelihood of underperformance relative to the U.S.

> "While we expect the U.S. equity market to channel its inner Captain America, leading the charge and heroically outperforming developed market peers, it's important to maintain balance, as even the most valiant hero needs a team."

While we expect the U.S. equity market to channel its inner Captain America, leading the charge and heroically outperforming developed market peers, it's important to maintain balance, as even the most valiant hero needs a team. Leaning too far to one side of the boat risks losing your footing entirely. Maintaining an allocation to global markets is prudent, as there are scenarios where other regions could shine. That said, our outlook supports tilting toward the U.S. market and capturing its distinct, superhero-like relative advantages.

CASTING A WIDER NET:

CAN THE MAJORITY TURN THE TIDE ON THE MINORITY

The seas of the market are vast and deep, yet in recent years, a few oversized fish have captured all the attention, creating waves impossible to ignore. These 'Magnificent 7' (Mag 7) stocks have powered equity markets to remarkable heights, overshadowing broader opportunities lurking just below the surface. As we peer into this year, it's time to explore beyond familiar waters. Casting a wider net for opportunities within U.S. equities will be key for investors aiming to uncover the hidden potential of 2025.

In our previous outlook, Defying Gravity, we argued that the Mag 7 couldn't defy market forces forever after contributing a whopping 63% to the index's return.

Mag 7 Has Helped Fuel S&P 500 Performance

Indexed to 100 on 1/1/2021, price return

Returns	'21	'22	'23	'24
S&P 500	27%	-19%	24%	23%
S&P 500 ex-Mag 7	17%	-8	8%	10%
Magnificent 7	40%	-40%	76%	48%
*Share of returns***	*33%*	*56%*	*63%*	*55%*

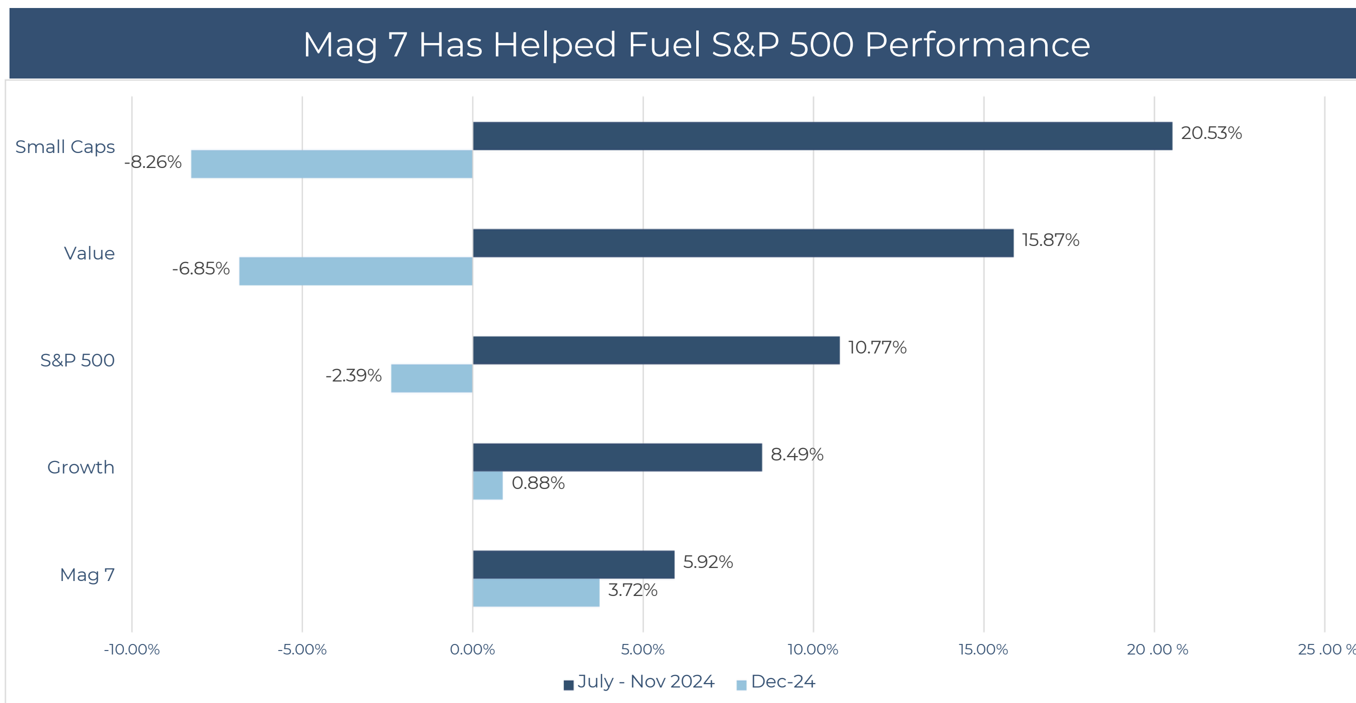
Source: JP Morgan Guide to the Markets. Data as of December 31, 2024
***Share of returns represent how much each group contributed to the positive despite negative performance in 2022*

That what goes up must eventually find balance and be recalibrated. It was predicated not that the group would underperform, but that its dominance would begin to wane. After the 63% contribution, that number fell to a still astounding 55% in 2024, defying expectations. As we look to this year, we argue that market conditions are riper for a more substantial erosion of this dominance.

The real treasure lies in incorporating overlooked corners of the market into investors' portfolios, extending beyond the focus of the Mag 7.

> "The stage is set for the smaller fish in the sea to make a splash."

With a resilient economy, prospects of rate stabilization, supportive policies from the new administration, and transformative artificial intelligence (AI) waves migrating to other areas, the stage is set for the smaller fish in the sea to make a splash. This tide began to shift in the second half of 2024, as markets began pricing in outcomes of the then upcoming election, anticipated Fed rate cuts, and stable economic growth. These conditions allowed areas away from mega-cap tech to outperform. However, the recent rise in yields and increased volatility has posed challenges to this momentum, reminding investors of the complexities in navigating these new waters.



Source: Bloomberg, Waterloo Capital.

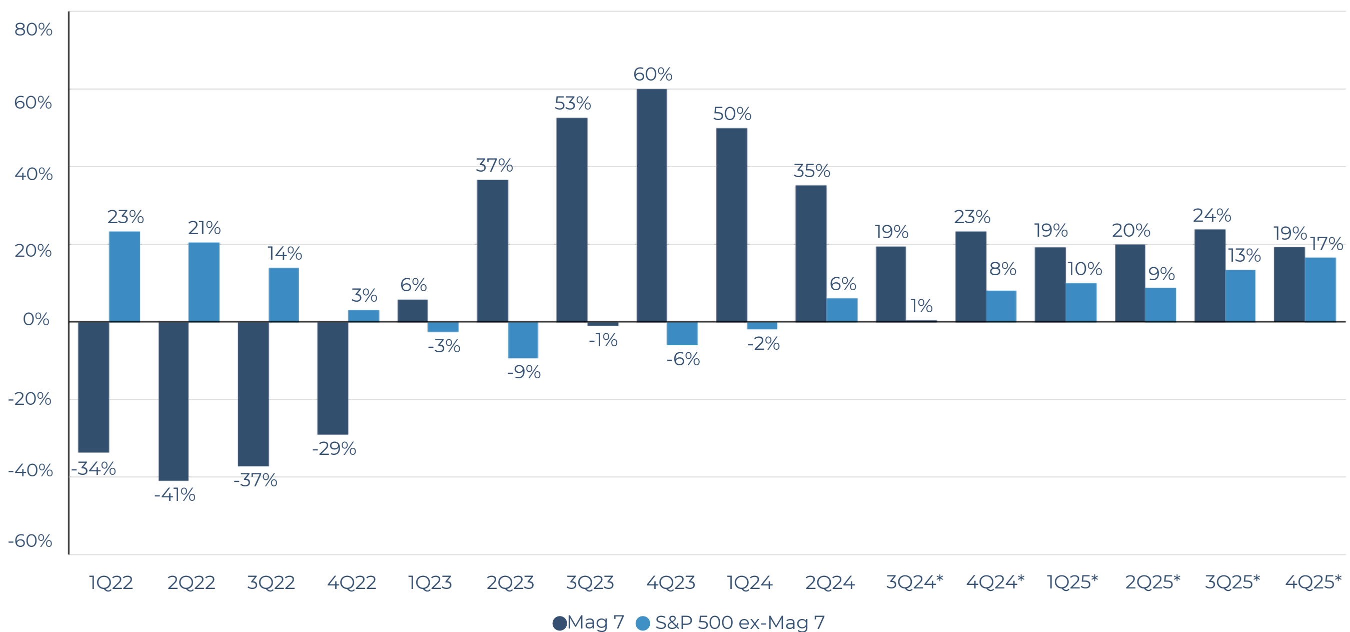
We still see compelling opportunities within this space; however, you'll need a smaller boat to take on what lurks below. Success depends on agility and precision, as being selective will be key to avoiding potential pitfalls in lower quality areas. Certain cyclical sectors are well-positioned to benefit from a robust consumer base and a resilient economy, while Financials could gain traction from policy shifts coming out of Washington, offering promising prospects for growth. We're also focusing on specific opportunities in data centers and energy, as the expanding influence of AI continues to drive demand for computing power and sustainable energy solutions.

The driving point of this theme in 2025 is that the market landscape should provide better tailwinds for equities broadly, particularly on the earnings front. While index-level earnings growth is set to accelerate, the real story lies below the surface: a shift in the composition of this growth. Diving deeper, the extraordinary earnings growth of the Mag 7 is expected to wind down from its elevated levels, creating room for other areas of the market to shine. The focus here isn't solely on the level of earnings but on their rate of change. This dynamic opens the door for the other 493 names in the index, whose earnings growth is reaccelerating, to close the gap and play a larger role in supporting market returns.

> "The door is open for the other 493 names whose earnings growth is reaccelerating, to close the gap and play a larger role in supporting market returns."

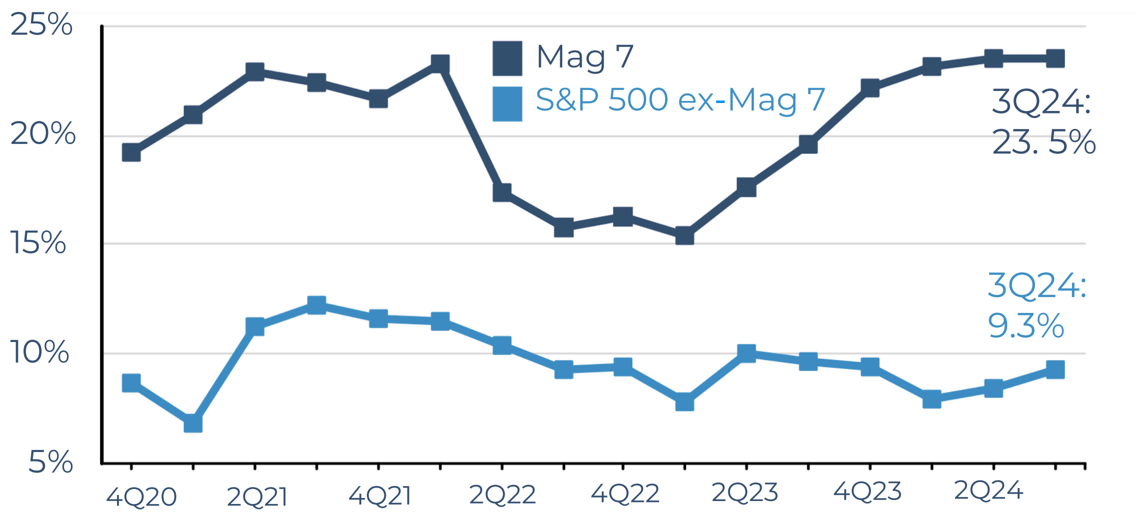
As Mag 7 Earnings Growth Decelerates in 2025, the Rest of the Market Catches Up

Exhibit 3: Pro-forma EPS, y/y



Source: FactSet, J.P. Morgan Asset Management. Data are as of November 15, 2024.

Though the Mag 7 may see a deceleration in earnings growth, it's worth noting that they're slowing from historically high levels of growth and profitability. These mega-cap giants aren't falling behind, they're simply shifting gears. The pendulum isn't likely to swing too far as they continue to benefit from strong secular tailwinds. Their operational efficiency, cost leadership, and dominant market positions have enabled robust free cash flow and profit margins nearly twice those of their peers. Downside risks such as slower economic growth or unfavorable monetary and fiscal policy shifts, remain in play, but these giants are uniquely positioned to weather these storms as seen in December. If uncertainty in markets reigns supreme, investors will likely place a premium on quality, potentially sparking a flight to safety trade further supporting the Mag 7.



> "These mega-cap giants aren't falling behind, they're simply shifting gears."

The narrative is evolving, not dying. While the Mag 7 can still deliver outperformance, it won't mirror the meteoric and disproportional gains of recent years. The broader market is beginning to show signs of life, presenting intriguing opportunities beyond these mega-cap names. However, this isn't a call to abandon ship. Portfolios should aim for balance, recognizing the potential in other areas while still appreciating the enduring strength of these titans. Don't count them out, just adjust expectations.

WATERLOO CAPITAL

Investment Implications

Tactical Decision	*2025 Allocation Outlook*
Relative Risk	Risk Off ← → Risk On
U.S. Equity Style	Value ← → Growth
U.S. Market Cap	Large -Cap ← → Small-Cap
Regional Equity Selection	U.S. ← → Non-U.S.
Non-U.S. Equity Market Preference	Developed ← → Emerging
Fixed Income Quality	Investment Grade ← → High Yield
Fixed Income Duration	Short ← → Long
Regional Bond Selection	U.S. ← → International

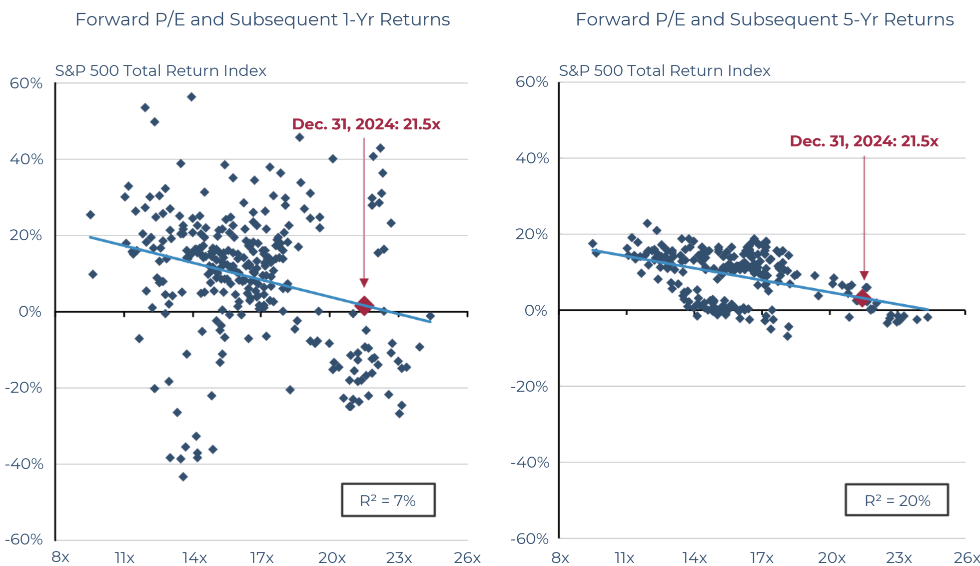
Source: Waterloo Capital

Equities

Domestic Equities:

As with any year, it's crucial to recognize that starting points matter when evaluating future returns. In recent years, valuations have continued to climb, despite rising interest rates and noisy economic data. While valuations offer a useful lens to view potential returns, they shouldn't be considered in isolation. Economic growth, corporate earnings, and shifts in interest rates all play critical roles in shaping market outcomes. As we enter 2025, the S&P 500's forward price-to-earnings (P/E) ratio stands at 21.5x, suggesting the likelihood of low single-digit annualized returns over the next five years and minimal gains in the near term. Historical trends indicate that overvalued markets, like the current one, often lead to lower future returns. However, relying exclusively on valuations for short-term projections is unreliable, as their statistical significance is weak, and other factors can overpower their influence.

Valuations Suggest Lower Returns in the Future



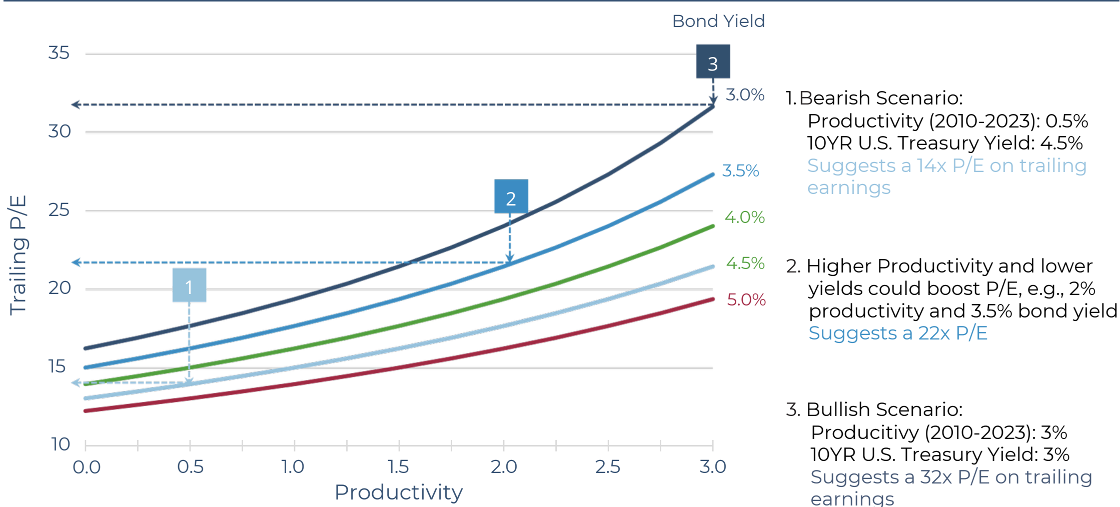
Source: FactSet, Refinitiv, Datastream, Standard & Poor's, Thomson Reuters, J.P Morgan. R^2 represents the % of total variation in returns explained by Fwd P/E ratio.

The recent rise in P/E ratios to historically high levels reflect both the transformative potential of the Artificial Intelligence (AI) revolution and renewed optimism around pro-growth policies aimed at boosting productivity and after-tax earnings.

Whether these lofty valuations can be sustained hinges on two critical factors: the extent to which AI can deliver on its promise of enhanced productivity and the trajectory of bond yields in the coming years.

Consider these scenarios: If AI-driven productivity growth accelerates to 3% and bond yields decline to 3%, valuations could stretch to a remarkable 32X P/E. Conversely, if productivity stagnates at the 0.5% pace seen in the last decade and yields remain above 4.5%, a 14X P/E would be more in line with historical trends. Given this wide dispersion of outcomes and the long but uncertain path getting there, equity sensitivity to data surprises will likely be amplified.

Stock Market P/E Could Be Higher than the Historical Average: Depends on AI's Productivity Boost and Where Bond Yields Settle



Source: Bloomberg, BLS, Columbia Threadneedle Investments, Data as of December 31, 2024

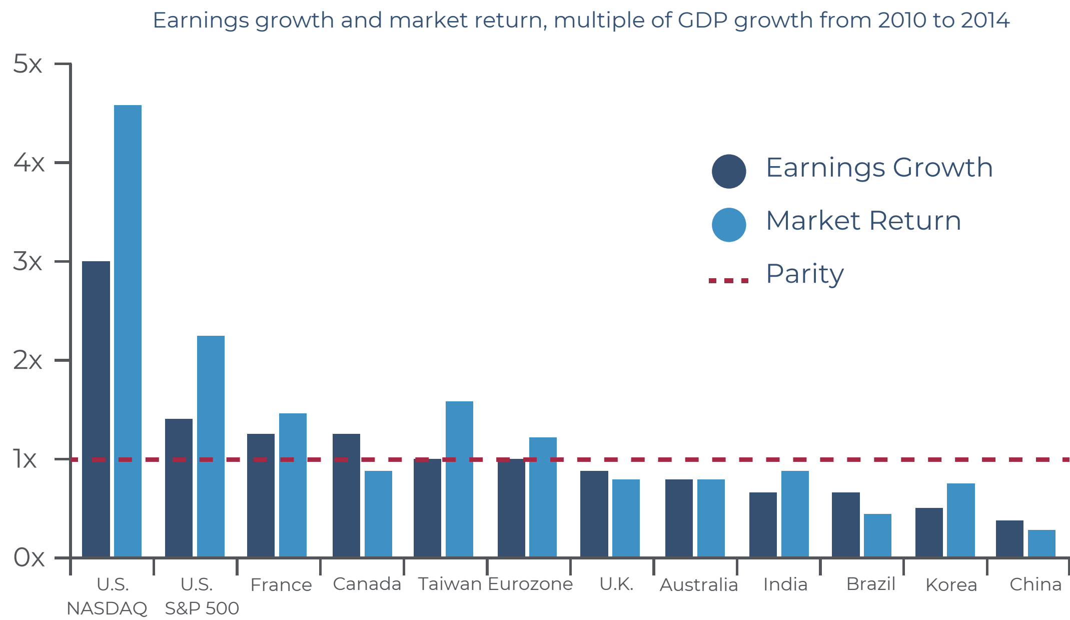
Amid elevated valuations and heightened market sensitivity, it's crucial to examine the key drivers of equity returns; earnings growth, changes in P/E multiples, and dividend yield. Last year, a significant P/E ratio expansion drove outsized returns. However, this year we expect to see a modest contraction in multiples as higher risk premiums and the continuation of elevated interest rates are likely to offset productivity gains. **With the dividend yield of the index remaining largely unchanged, earnings growth will determine the path of how equity markets perform in 2025.**

Source: Waterloo Capital

We anticipate strong earnings growth at the index level in the coming years. S&P 500 earnings are expected to have rebounded from stagnant growth in 2023 to a 9% increase in 2024, accelerating further to 12% in 2025, and a healthy 13% in 2026. While we largely agree with the 2025 projections, particularly given the momentum from the AI boom, economic resilience, and potential favorable tax policy shifts - risks remain. Adverse policies and unexpected shocks, such as widespread tariffs or a weakening labor market, could quickly temper these expectations, rendering current estimates overly optimistic.

Notably, U.S. earnings growth is significantly outpacing that of other regions, reinforcing our rationale for recommending an overweight allocation to domestic equities.

Earnings and Returns Lag GDP Growth in Many Foreign Countries

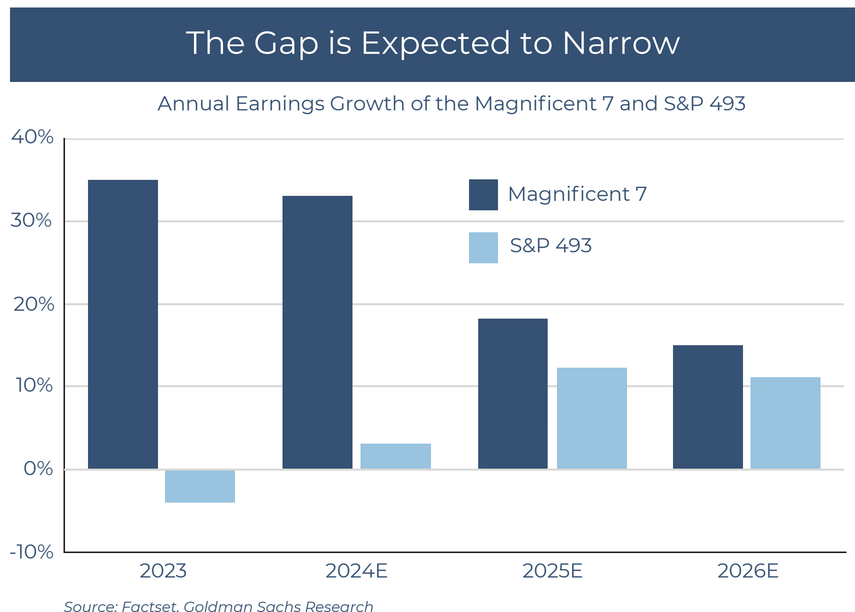


Source: Bloomberg, Michael Cembalest, J.P. Morgan Asset Management. Data as of 2024

The results speak for themselves. Over the past two years, U.S. equities, as represented by the S&P 500, have surged by more than 50%, driven primarily by the exceptional performance of the Magnificent 7. These mega-cap leaders accounted for an impressive 63% of the total return in 2023 and 55% in 2024, solidifying their market dominance. While we expect their strength to continue into 2025, the current market environment is presenting opportunities to diversify and identify growth beyond these key players.

The extraordinary earnings growth that powered the Mag 7's outperformance is expected to slow, while earnings growth across the remaining 493 companies is projected to pick up steam. Additionally, valuations outside of the Mag 7 appear more reasonable, setting the stage for a more inclusive rally, with the dominance of the few broadening out to the many. This isn't a call to abandon ship on the mega-caps, they remain dominant for good reason. Yet, we believe that their relative returns are likely to normalize, creating opportunities for other sectors and smaller names to shine. By complementing these market giants with exposure to areas poised for growth, investors can cast a wider net and tap into new opportunities likely to drive leadership in 2025.

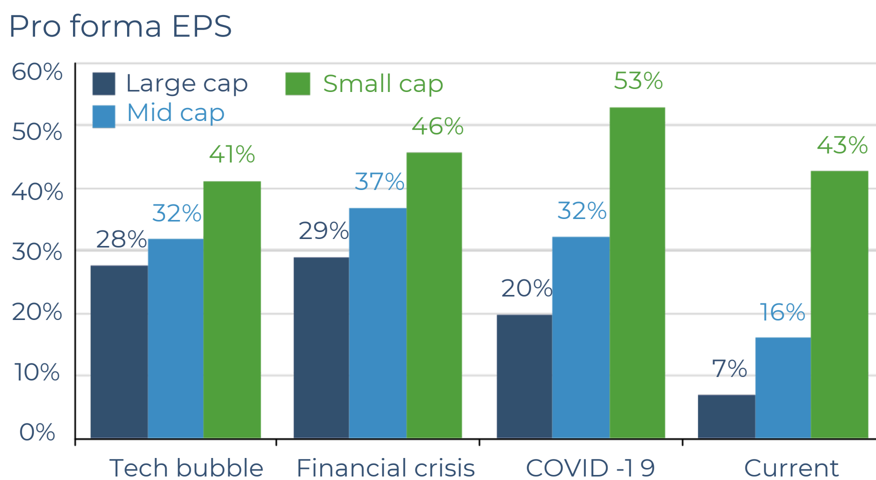
We believe Financials are poised to benefit from proposed deregulation under the new administration, rising loan demand, and a more favorable yield curve. Industrials and energy, which have struggled in recent years due to weak manufacturing activity, could rebound if rates decline, lowering the cost of capital.



Meanwhile, secular trends like AI and the energy transition are positioned to drive growth, propelling specific industries such as engineering and construction, data centers, nuclear power, and advanced cooling and electrical technologies.

While we favor these sectors, we maintain an overweight allocation to large caps. Small-cap names could see marginal improvement in 2025, especially given the acceleration in earnings growth, yet strong headwinds remain. Small caps are highly reliant on both operational and financial leverage, making their performance highly sensitive to interest rate movements and broader economic conditions. The brief drop in rates in the fall of last year showcased the potential upside for small caps, but the recent rebound in yields has put renewed pressure on the space.

Notably, nearly half of small-cap companies are currently unprofitable, compared to just 7% in the large-cap universe, reinforcing the elevated risk in this segment. A focus on higher-quality names with strong balance sheets and durable growth drivers will be key in 2025. In a year where macro uncertainty persists and rates remain a wildcard, large caps, with their stability, profitability, and durability in in the face of financial headwinds, remain the more compelling choice for broad portfolio exposure.



Source: J.P. Morgan Guide to the Markets

Achieving mid to high single-digit returns in 2025 will depend on a delicate balance of factors: solid earnings growth, rate stabilization, AI-driven productivity gains, and the broader market pulling their weight. Upside surprises, such as stronger-than-expected productivity increases, favorable policy shifts, or a more pronounced decline in interest rates without economic slowdown, could push returns even higher. However, elevated valuations leave the market exposed to risks and fault lines are abundant. Economic shocks, monetary or fiscal policy missteps, elevated geopolitical tensions, or slower-than-anticipated AI productivity gains could all provide headwinds and ultimately dampen returns. Additionally, geopolitical tensions, policy missteps, or weaknesses in the labor market would also clearly create headwinds.

Overweighting domestic markets, staying more balanced within U.S. markets, focusing on quality, and identifying sectors and companies with durable growth drivers will be the key playbook for generating outsized returns in 2025.

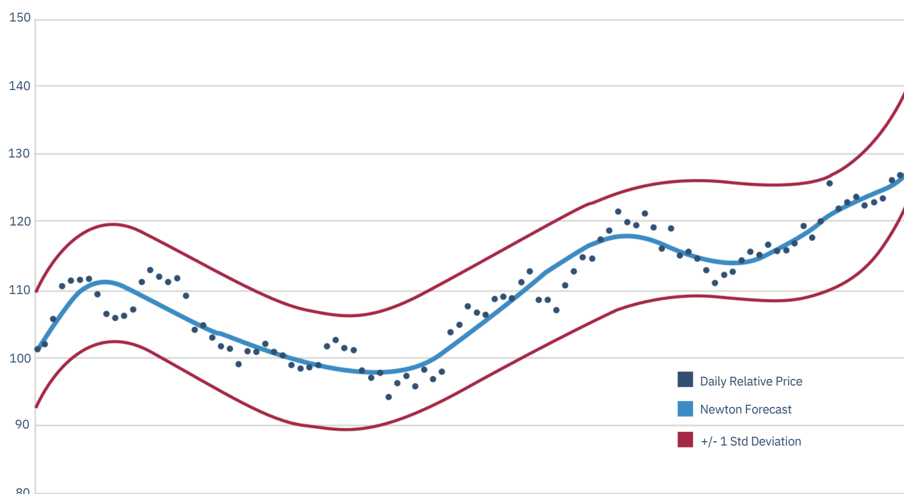
We Expect Equity Markets to Return Mid to High Single Digits

P/E RATIO (columns) / **Earnings Growth** (rows)

Earnings Growth	20	21	22	23	24	25	26
3%	-15.1%	-10.8%	-6.6%	-2.3%	1.9%	6.2%	10.4%
5%	-13.4%	-9.1%	-4.8%	-0.4%	3.9%	8.2%	1 2. 5%
7%	-11.8%	-7.4%	-3.0%	1.5%	5.9%	10.3%	14.7%
9%	-10.1%	-5.6%	-1.1%	3.4%	7.8%	12.3%	16.8%
11%	-8.5%	-3.9%	0.7%	5.2%	9.8%	14.4%	19.0%
13%	-6.8%	- 2.2%	2.5%	7.1%	11.8%	16.5%	21.1%
15%	-5.2%	-0.4%	4.3%	9.0%	13. 8%	1 8.5%	23.3%
17%	-3.5%	1.3%	6.1%	10.9%	15. 8%	20.6%	25.4%

Source: Bloomberg, Waterloo Capital. S&P Price of 5,881.63 and Earnings of 242.47 used for calculation. As of December 31, 2024

Waterloo Newton Chart



Source: Waterloo Capital, Illustration purposes only.

At Waterloo, we enhance this decision-making process by utilizing our high-order algorithmic screening and trend identification tool, Newton. Our Newton models, in conjunction with macroeconomic, fundamental, and technical analysis, serve as a mechanism for identifying opportunities to the upside and protecting portfolios on the downside.

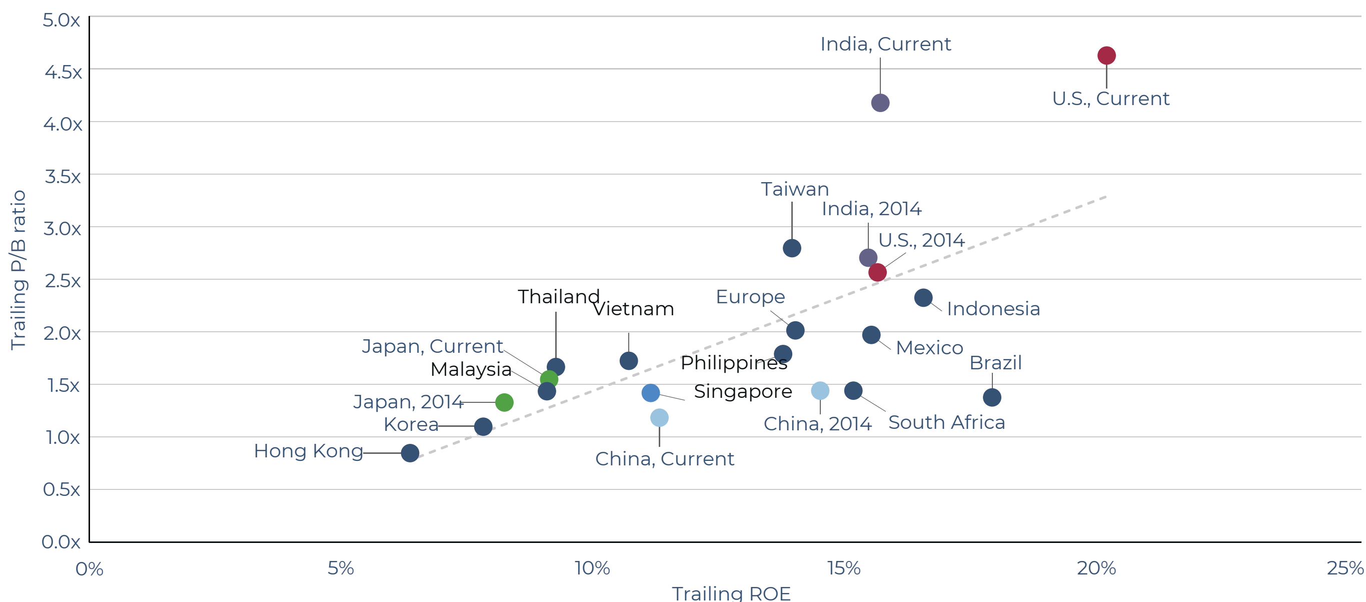
This means staying in harmony with underlying market trends and dampening outsized drawdowns. As more uncertainty enters the investment landscape, we pursue strategies that take advantage of attractive short-term opportunities while carefully managing risk. We believe in pressing the brakes during downtrends and accelerating during upturns, with a heightened focus on downside protection.

Equities

Foreign Equities:

In 2025, we remain underweight international equities. Although the significant valuation discounts in global markets compared to the U.S. are enticing, the headwinds facing international equities are simply too strong to ignore. A pro-U.S. agenda from the new administration and a stronger dollar driven by higher interest rates and continued tariff uncertainty poses significant challenges for global markets. That said, despite the risks, opportunities to diversify portfolios beyond expensive U.S. markets do exist. Successfully navigating international markets in 2025 will require a more active and selective approach to capitalize on pockets of potential growth.

India and Taiwan Offer quality Growth, While Japan and Korea Offer Value Linked to Corporate Reforms



Source: FactSet, MSCI, J.P. Morgan Asset Management. Data as of November 15,2024

The **Eurozone** faces an uphill battle in 2025, grappling with sluggish growth and mounting challenges. Growth is expected to limp along at just 0.7% for 2024 and 1.1% in 2025, emphasizing the region's struggles to gain economic momentum. High energy prices, the ongoing war in Ukraine, tariff uncertainties, and weak demand from key trading partners like China are creating a perfect storm of headwinds for the year ahead.

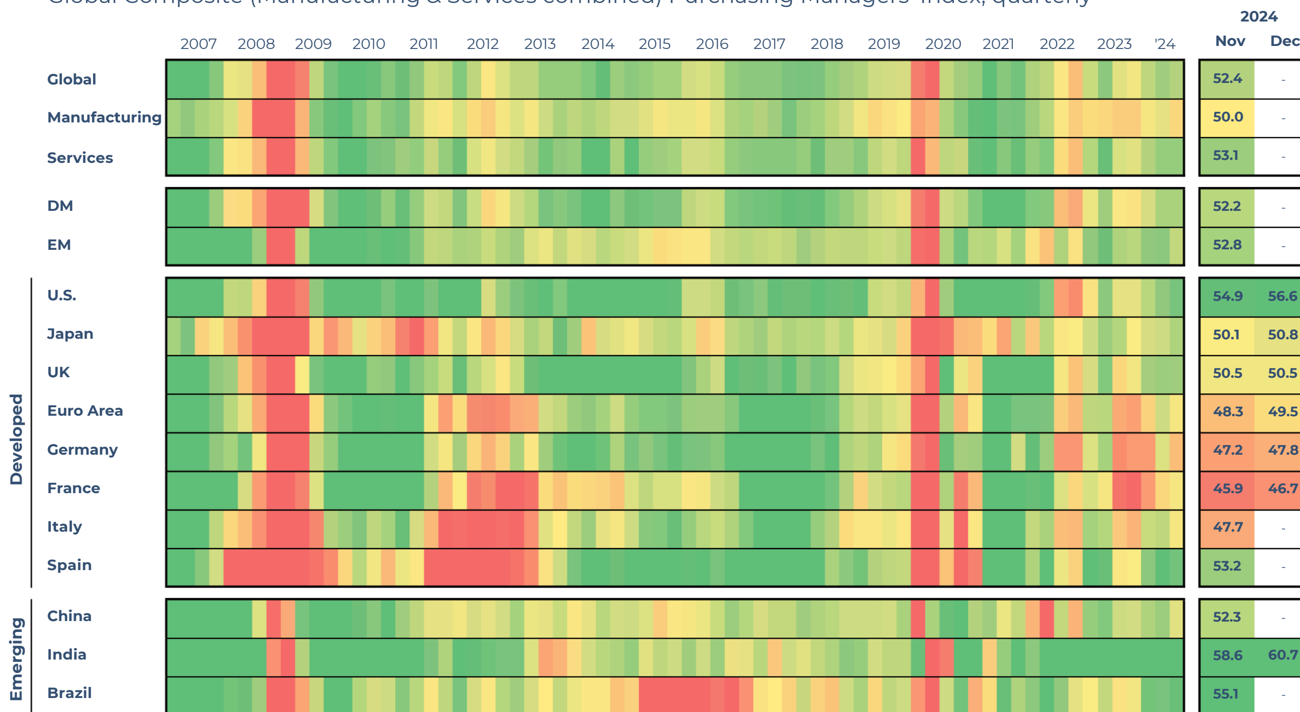
Germany, traditionally the bloc's economic engine, continues to struggle as persistent industrial weakness has left its growth stagnant since the pandemic. The Eurozone's situation took another dramatic turn in December when France's government collapsed, adding political instability to an already precarious outlook. The European Central Bank (ECB) is well aware of these challenges and will likely continue their rate cutting cycle into 2025. However, recent upside surprises in inflation have placed the ECB in a difficult position. For equity markets, this combination of slow growth, high uncertainty, and weak economic drivers paints a cautious picture. As the Eurozone navigates these challenges, their equity markets face an uphill battle to deliver meaningful performance.

In contrast, the **U.K.** is projected to lead European economies in growth and achieve the third-highest growth among G7 nations. On the central bank front, The Bank of England (BoE) recently held its key interest rate steady in December, marking the second pause in the last three meetings as it adopts a slower approach versus its peers. Market expectations suggest two rate cuts by year end, which could provide more economic support. However, like other central banks, the BoE must carefully manage upside inflation risks, leaving it in a delicate balancing act.

For U.K. equities, sector exposures differ significantly from those in the U.S., creating diversification opportunities. The U.K. market leans toward value-oriented sectors, with heavier weights in financials, energy, and basic materials, while its minimal exposure to technology provides a counterbalance to tech-heavy, U.S.-based portfolios. Opportunities are likely to emerge in select areas, such as growth focused utilities driving the energy transition. Additionally, the U.K.'s valuation discount appears more favorable than its peers, making it a potentially appealing option for investors seeking value in a challenging global market.

Global Economic Activity Momentum

Global Composite (Manufacturing & Services combined) Purchasing Managers' Index, quarterly

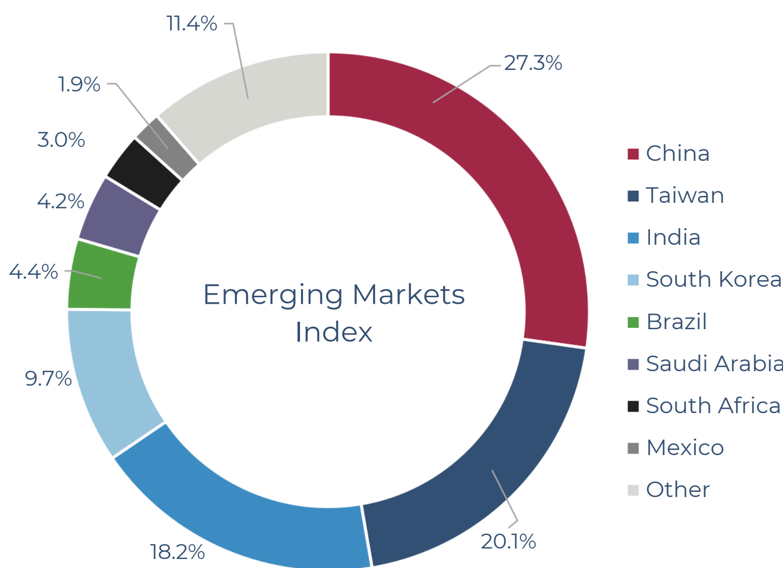


Source: J.P. Morgan Guide to the Markets, Data as of December 31, 2024

Japan stands as one of the few developed countries not in a rate cutting cycle. Instead, they are beginning to emerge from a prolonged period of deflation, stagnant growth, and negative interest rates, signaling a shift in its economic trajectory. Inflation remains at 2.9%, which could support consumer spending and domestic earnings growth, though the full impact remains uncertain. At the same time, Japan's ongoing corporate governance reforms and structural improvements are contributing to a more favorable investment landscape, which will likely continue to attract capital and bolster returns.

With that said, yen volatility remains a key risk, particularly following the August yen carry trade unwind, which heightened market concerns. While there is cautious optimism that yen stability might improve next year as Japanese interest rates gradually normalize, the disruptive rise in U.S. Treasury yields presents a significant headwind.

Although the Emerging Markets (EM) index encompasses more than **China**, the country accounts for roughly 30% of the overall weighting. Since the U.S. election, investors have viewed the incoming Trump Administration's policies as favorable for U.S. equities but detrimental for emerging market stocks, mirroring trends from Trump's first term. However, in 2017, this dynamic reversed as China drove Emerging Markets outperformance.



Source: iShares, ETF EEM was used for calculation

In 2025, a repeat of the 2017 reversal appears less likely. Government stimulus measures in China have so far produced only short-term, volatile effects rather than lasting economic improvements. Stabilizing the domestic economy, particularly through targeted measures in critical areas like housing, will be essential for unlocking potential gains in Chinese equities.

While these efforts could spark a short-term rally, China's history of overpromising and underdelivering on stimulus continues to erode investor confidence, making a smooth recovery unlikely. One thing is clear: investors should brace for a volatile ride until mid-year China policy announcements provide greater clarity on the country's economic and market trajectory.

Outside of China, there are promising opportunities in **Emerging Markets**. India is expected to have stronger earnings momentum next year with falling rates and stronger service export growth.

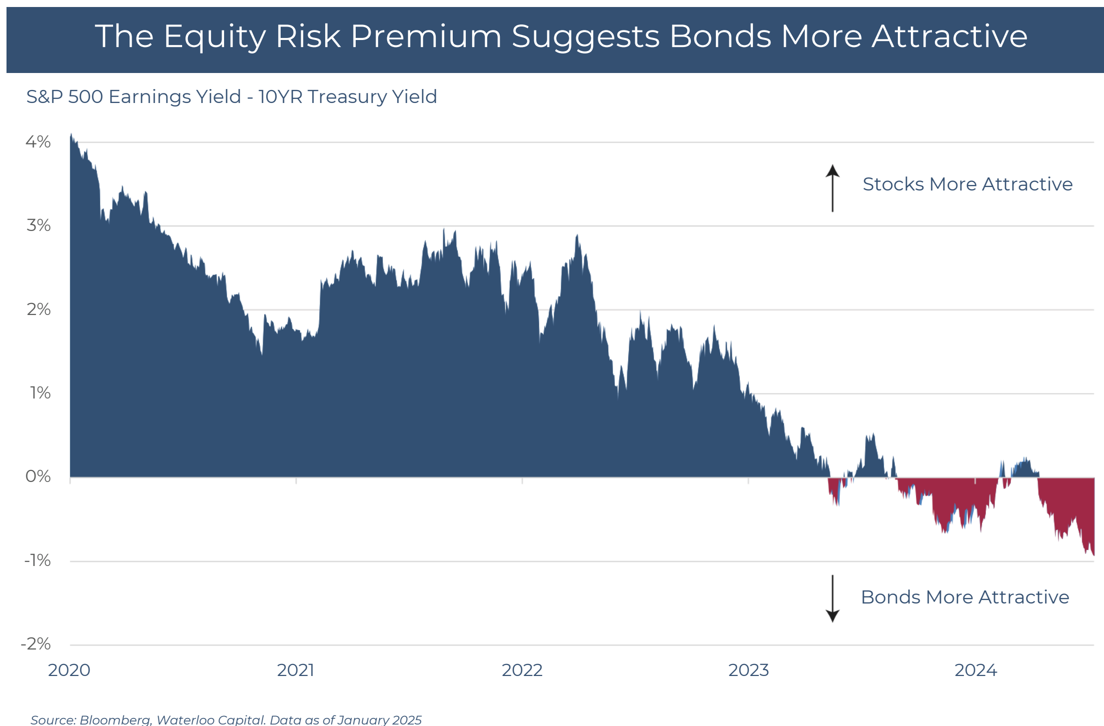
However, like the U.S., elevated valuations have stalled inflows into the world's 5th largest economy. Elsewhere in Asia, fundamentals are robust, with most Southeast Asia countries growing GDP around 5%. The AI and technology boom is providing a boost to Taiwanese companies, while South Korea faces headwinds from political volatility. If these challenges begin to ease, South Korean equities could start to participate more meaningfully. Mexico will likely see volatility next year as the 2026 USMCA renegotiations draw near. Additionally, the Trump administration may use trade negotiations as a bargaining chip in discussions around immigration and tariffs. However, the growing trend of nearshoring could be a critical tailwind for our neighbors down south. Overall, dollar strength and potential policies from the new U.S. administration are expected to weigh on Emerging Markets as a whole. Nonetheless, selective opportunities remain for investors willing to navigate the complexities of these markets.

> "In 2025, we remain underweight international equities. Although the significant valuation discounts in global markets compared to the U.S. are enticing, the headwinds facing international equities are simply too strong to ignore."

Fixed Income

Duration:

In recent years, investors have grown increasingly enthusiastic about the potential resurgence of U.S. bonds, backed by key fundamental metrics following a decade of low yields and dismal total returns. Among the most striking indicators is the equity risk premium, which suggests that the relative reward from stocks may no longer justify their elevated risks compared to bonds. This presents a clear and compelling strategy: buy bonds, clip your coupons, and prepare for outperformance. Currently, this signal is at its strongest point in this cycle, highlighting a divergence not seen since the late 2000's - the earnings yield for equities has fallen below the yield offered by a 10-year treasury bond.

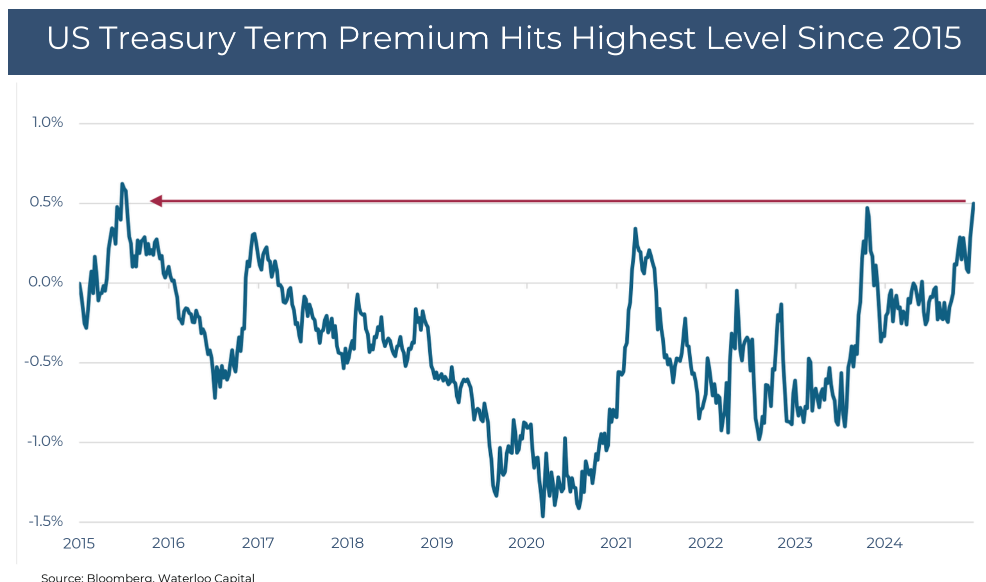


Despite this relationship flashing warning signs for over a year, equities climbed the proverbial wall of worry, delivering a historic rally, and leaving bonds in the dust. While the equity risk premium is a useful gauge, relying on it in isolation has proven inadequate as it fails to account for the potential strength of earnings growth within the equity market.

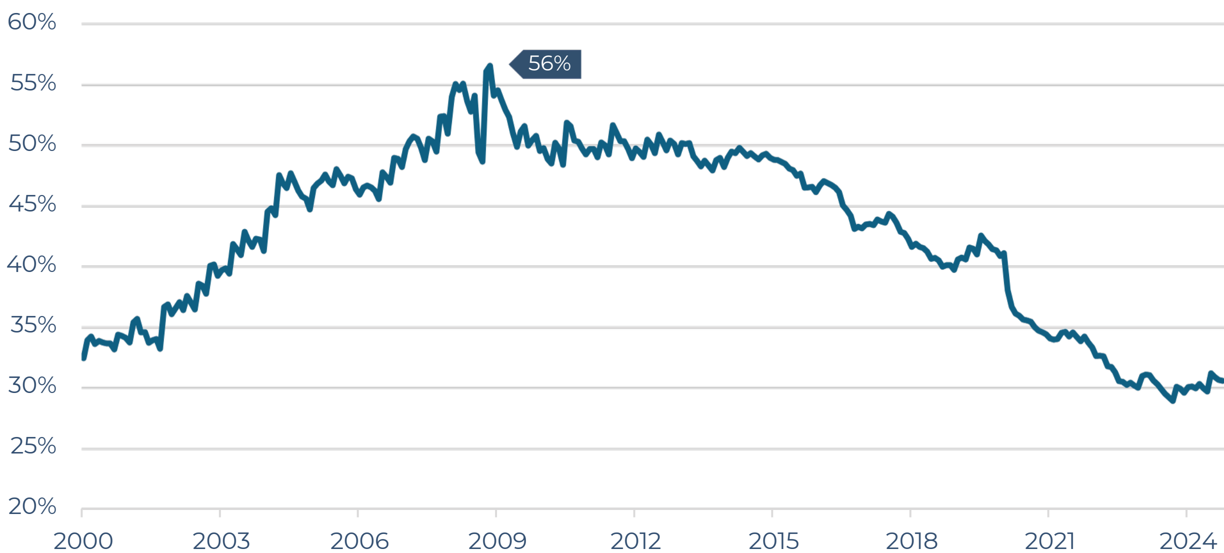
Zooming out, it appears that fixed income may finally have its long awaited resurgence. However, significant headwinds are gathering for the asset class in 2025 as we anticipate another volatile and challenging year for the U.S. Treasury market.

In late 2024, it was widely expected that this year was to be laden with rate cuts and dovish policy from the Federal Reserve. However, in a surprising shift at their December meeting, the Fed aligned more closely with the market's perspective, acknowledging that current economic data does not support the previously anticipated rate cuts. With inflation stubbornly above target, economic projections defying expectations, and the potential policy implications from a Republican-led U.S. government, the case for easing policy has grown increasingly unconvincing. This recalibration has driven rates higher across the market and the prospect of a cut-free 2025 suggests rates will remain in an elevated range this year.

This year investors should expect that the likely Fed inaction will exert upward pressure on yields, while other emerging forces at the farther end of the Treasury curve facilitate a floor. Longer-term rates, such as 10- or 20-year yields, are more heavily impacted by structural and economic factors. This influence presents itself in the term premium, the additional yield bond buyers' demand for longer dated treasuries over their shorter dated counterparts. Throughout 2024, we saw the term premium surge, reaching its highest point in nearly a decade as investors began pricing in rising expectations for inflation and economic growth.



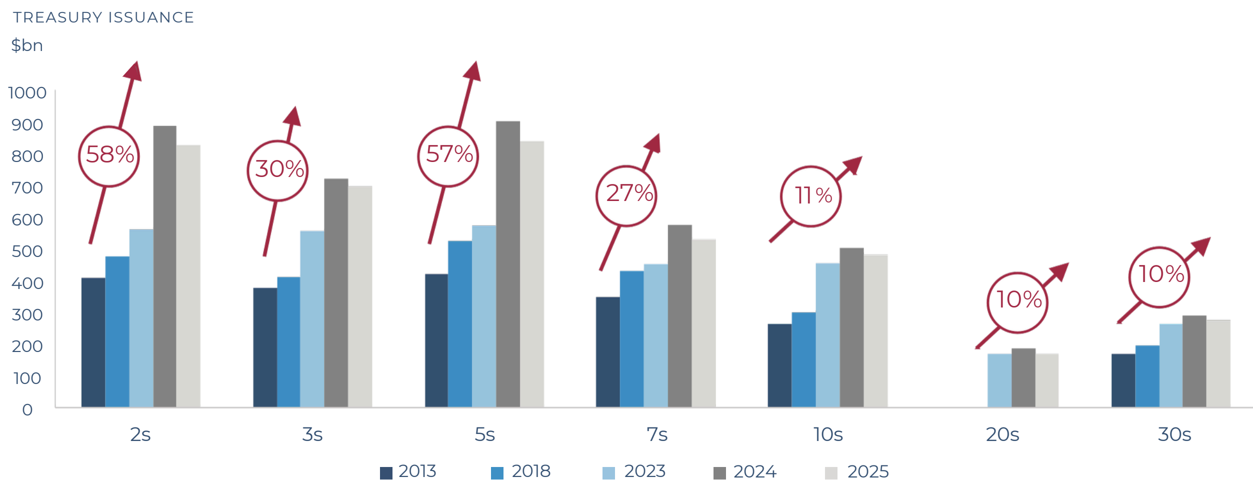
Contributing to this effect is the government's fiscal imprudence and seemly unstoppable deficit spending, which is becoming a consistent conversation among investors. As acknowledged by Waterloo, pundits, Congressmen, and even Fed Chair Powell himself, the U.S.'s unfunded spending is on an unsustainable trajectory that if left unchecked, undermines its ability to properly structure and service its debt. Through the end of last year, 17% of the entire yearly fiscal budget was allocated to cover interest payments on the $35 trillion debt balance. What was once considered a fringe issue has now entered mainstream discourse, spilling over into the long end of the yield curve. At Treasury auctions, bond buyers are demanding higher yields to offset the perceived increase in risk.



Source: Bloomberg, Waterloo Capital

These Treasury auctions are driving a massive shift in interest rate dynamics, with supply and demand playing a critical role in elevating the floor on rates. To fund ballooning government deficits, the Treasury Department issues bonds at auctions, where yields are determined by market forces. On the supply side, an influx of bonds has flooded the market, driven by increased fiscal spending and the constant need to refinance maturing debt. In just the first three months of 2025, the Treasury expects to issue a staggering $823 billion of notes. This abundant supply necessitates offering more compelling yields to attract buyers, translating to higher interest rates.

Treasury Auction Sizes Have Increased on Average 29% Across the Yield Curve in 2024



Note: Estimates from November 2024 to Dec 2024 from the Treasury Borrowing Advisory Committee and 2025 annualized using 1Q data from TBAC.
Sources: SIFMA, TBAC, Haver Analytics, Apollo Chief Economist

However, demand is not keeping pace, in fact, it is slipping. Foreign investors, primarily governments, who were once reliable purchasers of U.S. bonds are pulling back. In recent years, their relative demand for these instruments has declined, with the share of treasuries held in foreign reserves dropping from 48% in 2015 to just 31% by the end of 2024. If major buyers continue to retreat, the upward pressure on rates could intensify further, as even higher yields may be required to clear the growing inventory.

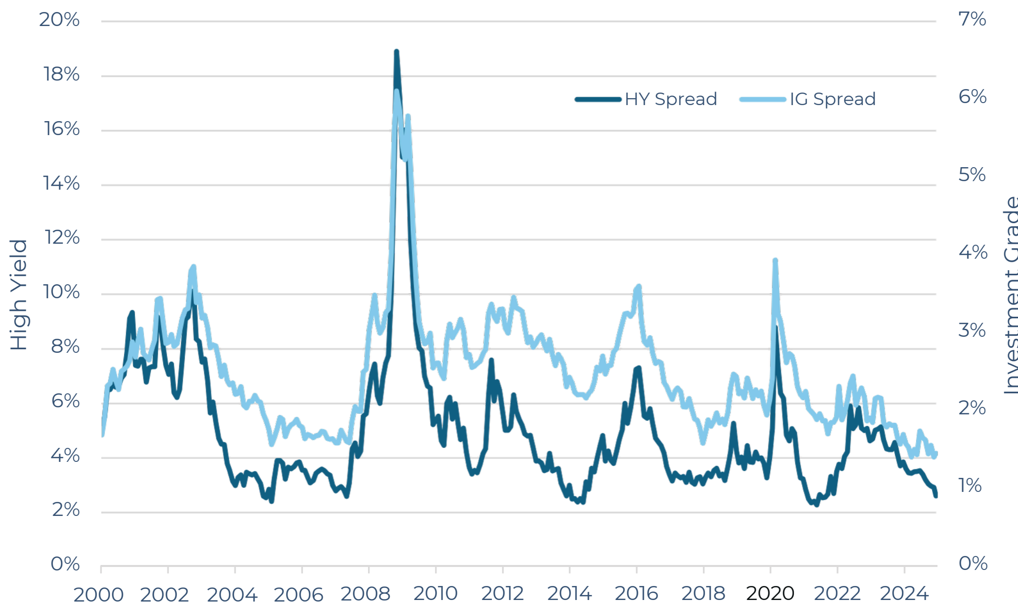
The confluence of these factors suggests that elevated market rates will persist this year, potentially weighing not only on fixed income returns but also equities and the broader global economy. However, it is crucial to keep perspective. While rates at these levels may feel unusually high in recent memory, the U.S. economy has operated and even thrived in far more challenging interest rate environments. Recency bias can often lead us to overreact, assuming that rates at their highest levels in years cannot be sustained and that some perceived anchor will pull them back to the "normal" of the last cycle. In reality, there is little evidence to support this assumption, and rates may very well remain higher for longer in this "new normal" environment.

Source: Bloomberg, Waterloo Capital. Data as of 1/22/25

At Waterloo, we tactically manage portfolio interest rate sensitivity to adapt to shifting market conditions. While our cautious outlook on rates leads us to favor an underweight in duration and capitalizing on still-attractive front-end yields, we remain attentive to the risks posed by a potentially weaker economy and the reinvestment challenges associated with a steepening yield curve. Despite skepticism about bonds' potential to outperform, their value as a diversifier persists, particularly as stock/bond correlations continue to weaken. As a result, we believe a gradual shift toward a modest underweight in interest rate exposure is prudent.

Credit:

Within corporate bonds, credit spreads serve as a key valuation method, representing the extra return investors demand for taking on credit risk. Currently, spreads in both the investment grade and high yield sectors sit at historically low levels, a signal that typically urges caution as investors may not be adequately rewarded for their risk taking. However, corporate bond investing extends far beyond simply monitoring spreads. Success in this space requires a nuanced strategy where performance is determined by a mosaic of factors.



The largest piece of this mosaic is the economic environment and business landscape in which these companies operate. Fortunately, we expect both factors to provide a supportive backdrop for corporate operational success.

A resilient consumer base, the continuation of AI investment, and ongoing fiscal spending are likely to drive another year of above trend GDP growth. Adding to the optimism, a highly business-friendly administration entering the fold is expected to bolster the ability of firms, particularly in sectors such as financials, to maintain solid fundamentals.

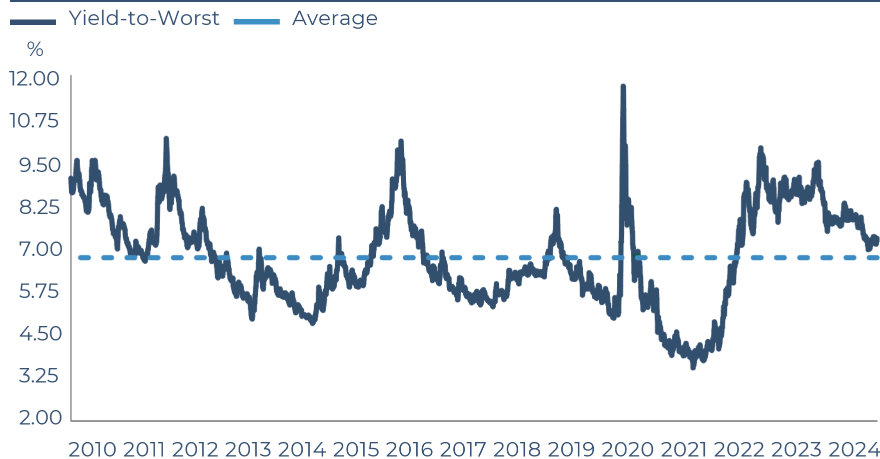
However, while the broader environment provides the foundation for healthy corporate fundamentals, a company’s ability to meet its debt obligations ultimately hinges on its financial performance. Key metrics such as leverage, the amount of debt on a firm's books, and interest rate coverage ratios, which measure a company's capacity to cover interest payments, remain above historical averages. In fact, unlike the government, the interest burden for most publicly traded borrowers is near all-time lows, leading to an upward migration in credit ratings and a decline of firms in distress. These trends collectively paint a picture of confidence in corporate debt performance, underpinned by both favorable economic conditions and sound financial discipline.

Corporate Net Interest Payments Near Record Lows (Excludes Financials)

Sources: Federal Reserve Board, Haver Analytics, Apollo Chief Economist. Data as of June 2024.

With broad business confidence and a supportive framework for corporate credit, we expect spreads to remain relatively rangebound near current levels, albeit with higher volatility than in recent years. As a result, we are overweight high yield corporate bonds.

Attractive Yields



Source: Bloomberg, Northern Trust, Waterloo Capital

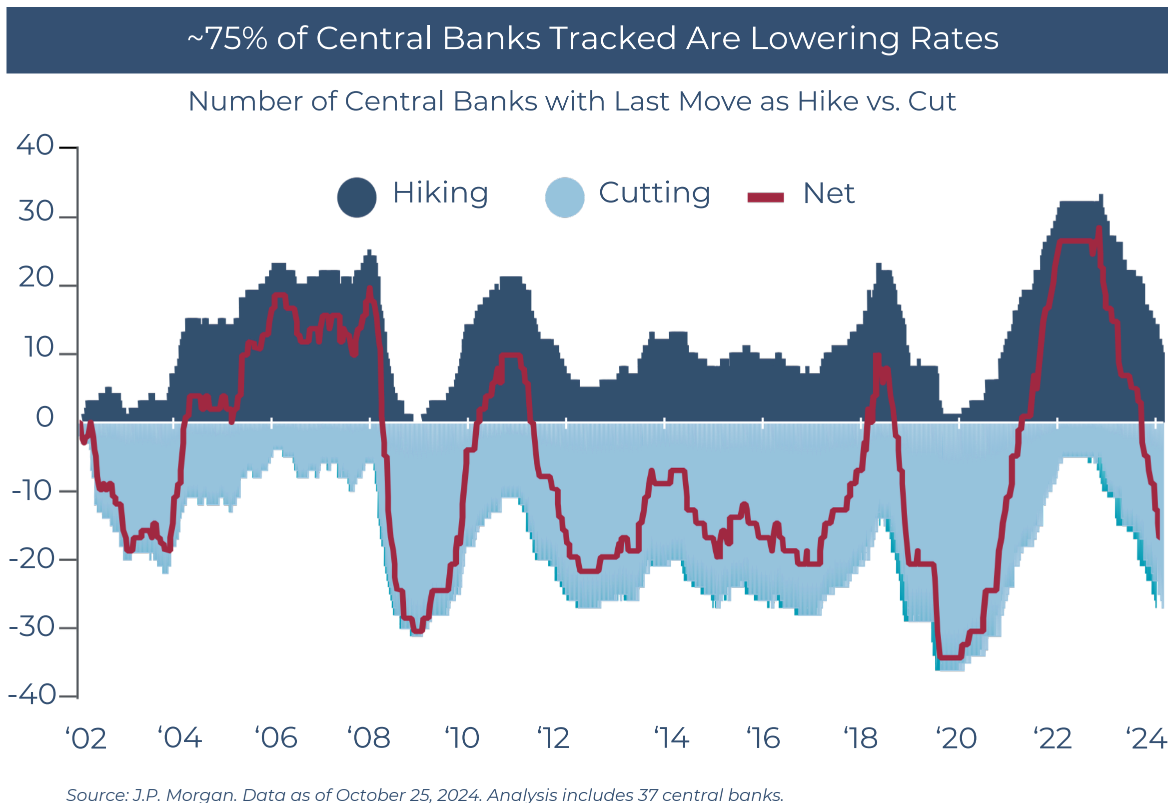
The attractive absolute yields in this space should help cushion total returns during bouts of volatility, mitigating moderate price fluctuations. Additionally, the lower duration profile of high yield bonds vs investment grade debt provides added protection from price deterioration in the event of an upward move in interest rates.

Beyond corporate issuers, compelling opportunities are emerging in the credit landscape. Spreads for mortgage-backed securities have stabilized at attractive levels after years of volatility driven by interest rate fluctuations. The potential for spread tightening toward their ten-year average, combined with low expectations for prepayments, reinforces the favorable outlook for this sector.

Should interest rates remain elevated and the credit environment stable, a scenario aligned with our base case, floating-rate loans could prove highly attractive. Their combination of elevated yields and low duration profiles positions them as an ideal choice for effectively navigating a prolonged higher-rate environment.

International:

As global central banks transition into rate-cutting cycles and inflation returns to more sustainable levels, the spotlight shifts to navigating uneven regional growth trajectories. In this evolving landscape, emerging markets and USD-hedged bonds stand out as compelling opportunities, offering a more attractive risk-reward profile compared to their developed market and local currency-denominated counterparts.



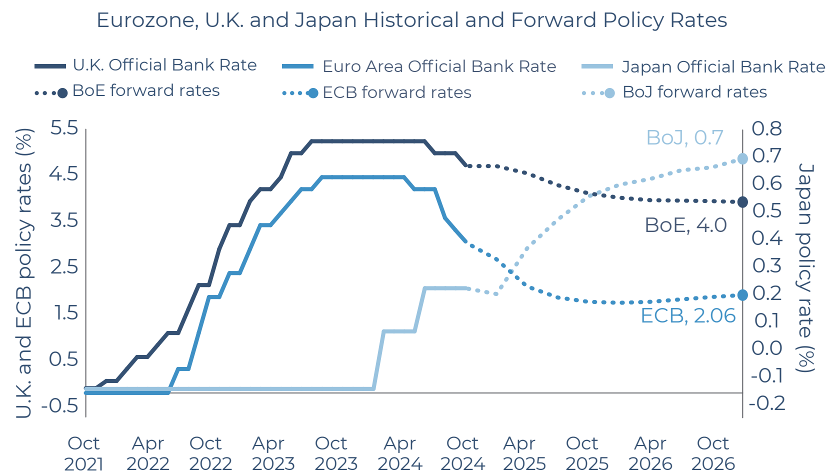
Source: J.P. Morgan. Data as of October 25, 2024. Analysis includes 37 central banks.

In **Europe**, the European Central Bank (ECB) is well into its cutting cycle and is expected to continue easing policy as inflation shows signs of moderation and growth prospects for the region remain fragile. Economic indicators, such as the purchasing managers' index (PMI), fell from tepid levels last summer and now hover in contractionary territory. Germany, the largest EU economy, faces the possibility of a third consecutive year of recession. This shaky backdrop compels the ECB to provide support, especially as substantial fiscal stimulus is unlikely to materialize. Relatively low starting yields in the 2% - 3.5% range and the market pricing in a serious rate cutting cycle make fixed income investments in Europe relatively unattractive.

Across the English Channel, the Bank of England finds itself in a stop-and-go easing cycle, as inflation in the **U.K.** remains higher than in mainland Europe. However, their growth outlook has also proven more resilient. Against this backdrop, markets expect additional rate cuts, though the process will likely be iterative, like the US policy situation. Yet, more prevalent economic risks introduce additional downside scenarios for rates, potentially driving them lower to provide support for their bonds. Compared to other developed markets, Gilts appear attractive given higher current yields and downside risks to the policy rate.

Japan's monetary policy stands in stark contrast to other developed markets. After years of easing policy and sub-zero interest rates, they were the last major economy to join the rate-hiking club in 2024. With inflation at 2.9% and a 10-year yield at 1.2%, real returns are expected to remain negative as policy rate hikes extend into this year. Given this dynamic, Japan's bond market appears less than compelling in 2025 and as a result, we anticipate avoiding of investments in this area.

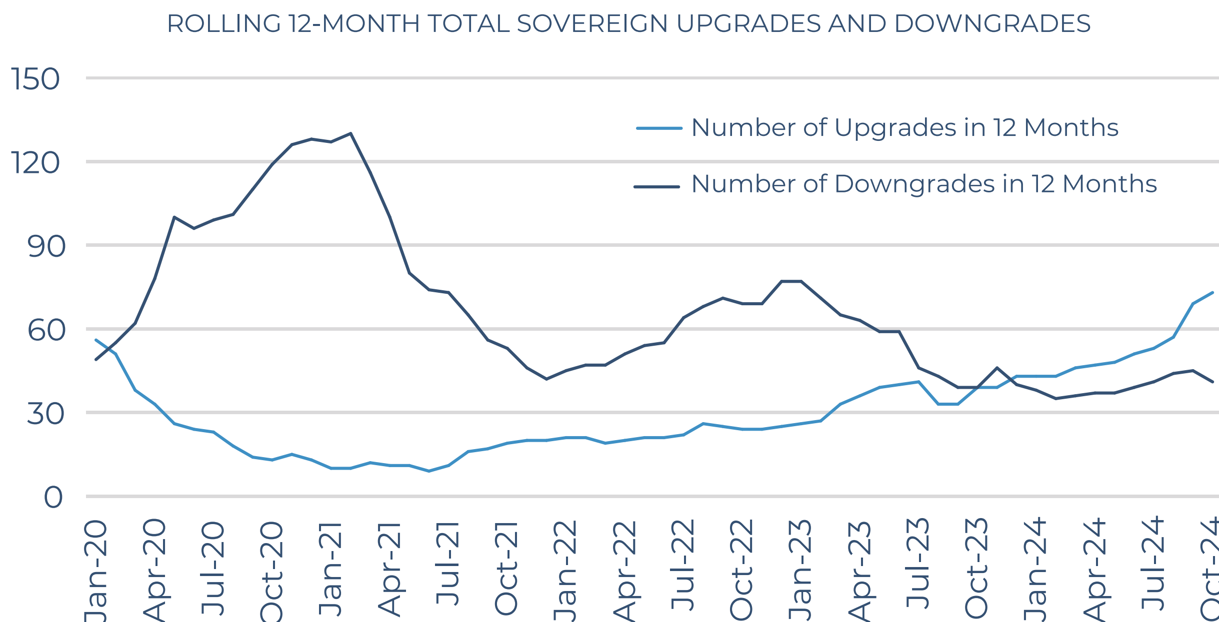
Japan's Monetary Policy is Divergent from Other Central Banks



Source: Northern Trust, Bloomberg, Historical policy rates shown are from Oct 2021 to Oct 2024. Forward rates are from Dec 2024 to Dec 2026. Data as of November 11, 2024.

Although **emerging market (EM)** fixed income is a diverse and multifaceted sector, ranging from powerhouses like China to up-and-comers like Nigeria, the current dynamics appear to set the stage for potential outperformance. GDP growth projections for EM economies remain broadly stable at 4.1%, as estimated by the World Bank while inflation is expected to moderate further worldwide. This environment creates opportunities for many countries to initiate or continue rate cuts, fostering a supportive foundation for EM. Government credit ratings in the sector have improved in recent years, recovering from shocks such as the Russia-Ukraine war and global rate-hiking cycles. Unlike other asset classes trading near all-time low spreads, EM spreads are closer to their historical averages, offering more attractive relative value. An allocation to this sector not only captures these factors that could drive outperformance but provides diversification benefits to a fixed income portfolio.

EM Government Credit Ratings Have Improved



Sources: Bloomberg LP, Fitch, J.P. Morgan, Moody's, S&P, Newfleet. Data as of October 31, 2024.

Real Assets

Metals:

In 2024, gold exceeded expectations by delivering over 25% gains, outpacing U.S. equities while shrugging off traditional headwinds for the asset class from rising real yields and a strengthening U.S. dollar. Key drivers behind this impressive performance included large central bank purchases, heightened geopolitical uncertainty, and the onset of global central bank rate-cutting cycles.

Looking ahead to 2025, gold's ability to shine may remain, though the landscape is much more complex. The outlook for U.S. interest rates will dominate its trajectory and, with the expected absence of significant rate cuts from the Fed, it will likely pose challenges. Higher rates tend to diminish gold's appeal as a non-yielding asset. However, other dynamics, such as the new administration's trade policies and upside growth surprises, could stoke inflationary pressures, reinforcing gold's reputation as a hedge against rising prices. Despite these mixed signals, gold's fundamental story remains compelling. Central banks are expected to maintain their appetite for the asset, and ongoing geopolitical tensions provide an additional layer of support. While higher rates may create headwinds, inflationary risks could keep the gold's rally alive.

Performance of Gold Prices Around the First Cut of Last 3 Fed Cutting Cycles

Index, 100 = day of first Fed cut. X-axis is trading days, 0 = date of first Fed cut

Source: J.P. Morgan Commodities Research

Despite copper navigating the combination of oversupply and slightly growing demand, these dynamics won't serve as its main drivers in 2025. Instead, U.S. trade policy will likely take center stage. If Trump moves forward with broad tariffs on major trading partners, it could muddy the waters for copper prices in the form of a higher U.S. Dollar, keeping pressure on the important industrial metal. China's sluggish economy isn't helping either, but the prospect of further stimulus into the economy could help support copper prices.

Oil:

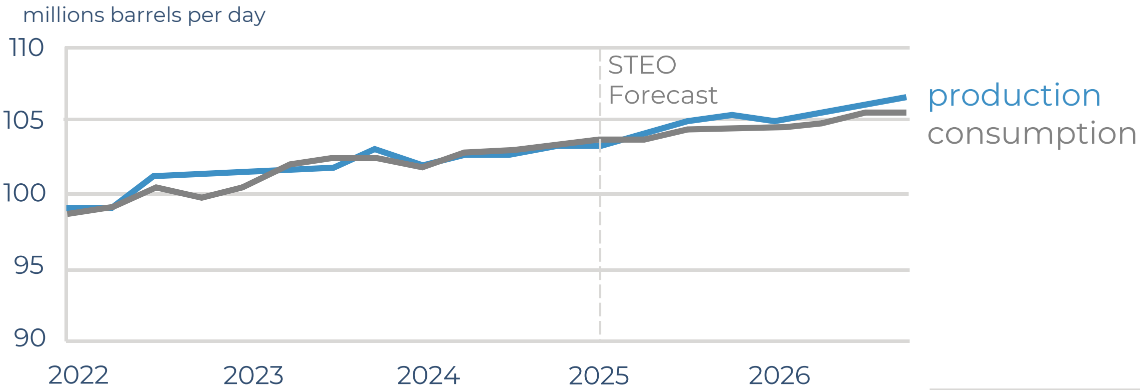
The energy world is bracing for a potential shakeup in 2025. With the Trump administration back in the driver's seat, markets are preparing for a meaningful shift in the legislative approach to energy policy compared to the Biden years. Specific areas such as liquified natural gas (LNG), refining capacity, and exploration and production (E&P) are already beginning rebound after an era of stagnation. This business-friendly regulatory environment has the potential to breathe new life into the sector.

LNG, the centerpiece of U.S. energy policy, faces an interesting path forward. Exports are on track to grow, but the big question is: how will foreign policy and tariffs impact international demand? Rising geopolitical tensions or the implantation of tariff policies could disrupt plans for expanding LNG into key markets, like Asia and Europe. The eventual answer will lie in how the U.S. manages its energy partnerships in an increasingly competitive global market.

Meanwhile, OPEC's position as the primary player for energy price stabilization is looking shakier than ever. The group is caught between keeping prices high and meeting the growing production demands of its member nations, many of which heavily rely on oil revenues to fund their economies. Simultaneously, U.S. shale producers aren't making things any easier. Thanks to continued innovation, shale production has become incredibly efficient, with oil generated here now firmly established as the marginal barrel setting the global price curve. With shale producers pumping away at lower costs, OPEC has no choice but to adapt or risk losing more market share.

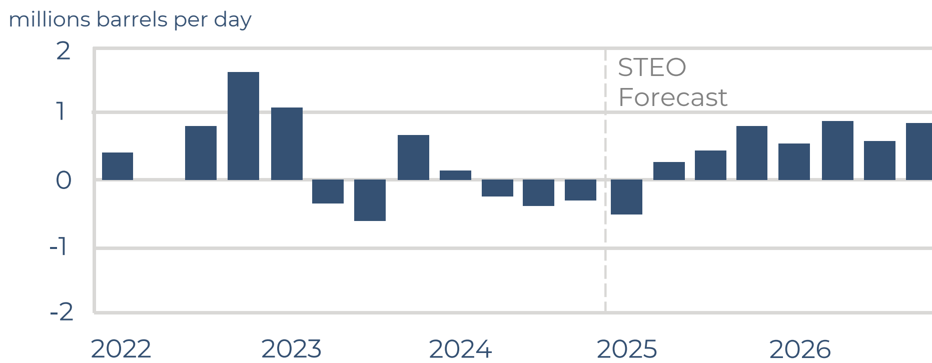
Forecasts Call for Lower Oil Price in 2025 Amid Significant Market Uncertainties

Quarterly World Petroleum Production and Consumption



petroleum stocks increase when production exceeds consumption....

Quarterly World Petroleum Stock Change



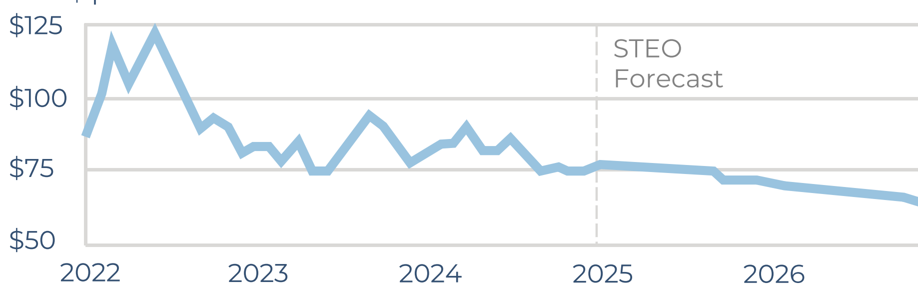
Implied Stock Builds

Implied Stock Draws

....and as stocks increase, crude oil prices tend to fall

Monthly Brent Crude Oil Price

$ per barrel



Brent Crude Oil Prices

Source: U.S. Energy Information Administration, Short Term Energy Outlook (STEO) January 2025.

Looking ahead, oil prices in 2025 are likely to stay somewhat depressed. Global production growth is expected to outpace slower demand growth, putting downward pressure on prices. This drag is expected to outweigh the risks of geopolitical flare-ups and any voluntary production cuts by OPEC members.

Cryptocurrency:

The cryptocurrency market entered 2025 with significant momentum, fueled by widespread adoption, regulatory advancements, and evolving technology. The explosion of Bitcoin ETFs and increasing interest from institutional investors have encouraged liquidity, solidifying Bitcoin's status as an established asset class. While macroeconomic factors could introduce short-term volatility, Bitcoin's long-term appeal remains intact, supported by investor sentiment and growing global recognition.

Bitcoin 2024 Events and Milestones

Source: Coinbase, Bloomberg, Waterloo Capital

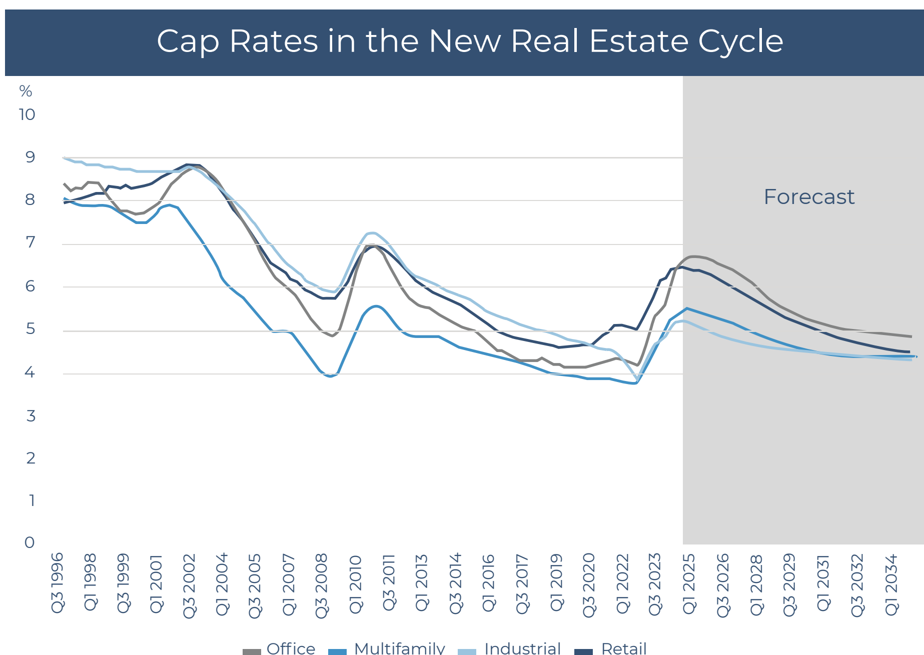
Ethereum occupies a critical role in the evolving crypto landscape, though its dynamics differ drastically from Bitcoin. Institutional interest in Ethereum has grown with the approval of spot ETFs, but inflows significantly trail Bitcoin's volume. The reason lies in their distinctive use cases, as Bitcoin's dominance stems from being a perceived store of value and strategic reserve asset, while Ethereum's appeal lies in its use as infrastructure for decentralized finance (DeFi) and tokenized real-world assets (RWAs). As the crypto ecosystem expands, Ethereum's integration into tokenized markets and DeFi applications increases the likelihood of its continued relevance. However, it faces challenges from emerging competitors and its fragmented Layer-2 ecosystem.

Real Estate:

Following several years of above-trend equity market performance and suppressed real estate prices, many investors have developed a sizable underweight to real assets. Sectors such as commercial real estate, infrastructure, and certain segments of the energy market offer compelling opportunities for diversification and inflation protection. With above-trend inflation expected to persist, real assets can provide a natural hedge by delivering inflation-linked income and intrinsic value growth.

Real estate has endured a challenging period. Over 18 months beginning in March 2022, the Federal Reserve embarked on an aggressive tightening cycle, raising rates at a pace not seen since the late 1970s. This, coupled with shocks from the pandemic, surging construction completions, and high inflation, strained valuations and impacted returns across all property types. However, 2025 appears poised to mark a turning point.

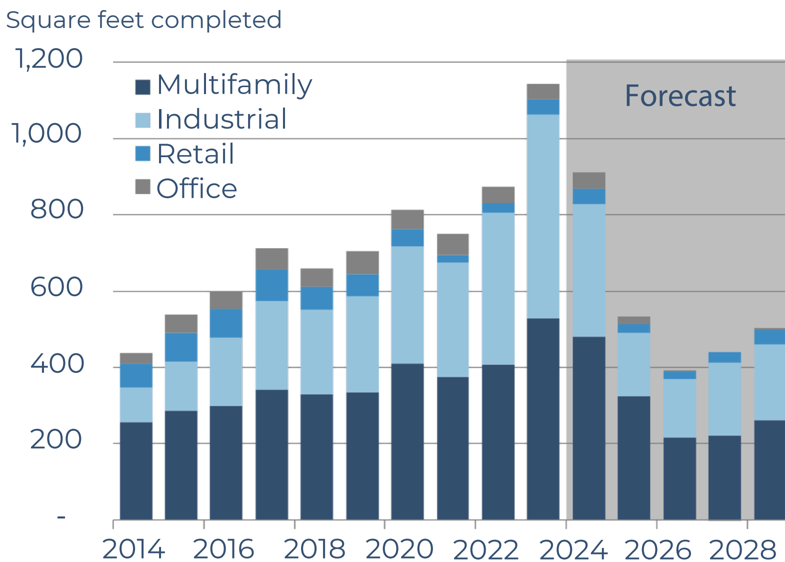
Over the past three years, valuations across all real estate sectors have declined significantly, with cap rates in traditional sectors rising by 200 to 400 basis points. Despite challenges, commercial real estate fundamentals are relatively strong entering 2025. Multi-family and industrial properties have weathered the storm well, and even the office sector is showing signs of improved leasing activity. Property values now appear to have bottomed, creating an attractive entry point for investors. Though interest rates remain higher than they've been and borrowing costs have increased, projected levered returns are 2-3% higher on average for the same risk.



Source: CBRE. Data as of October 10, 2024

We think 2025 will mark the start of a new cycle and that investors entering the market today will outperform prior vintages. Multi-family and industrial sectors have been hit recently with a wash of new supply in most market, keeping rents depressed and net operating income stagnant. A record number of new apartments opened in 2024, pushing vacancies up by a half percent despite strong demand. The national vacancy rate climbed to 8.9% in the fourth quarter—which is the highest level on record, primarily driven by the delivery of more than 530,000 new units throughout the year.

CRE Net Deliveries by Year



Sources: CoStar, as of March 31, 2024. Note: Multifamily data converted from # of units by assuming average unit is 900 sq. ft.

However, this new supply risk is quickly diminishing. Construction activity has fallen 40% from its peak, with new starts at its lowest level since 2012, which should be beneficial for rent growth moving forward. High interest rates, weaker effective rent growth, and rising replacement costs continue to hinder new development. Most apartments slated for delivery by 2028 have already broken ground, setting the stage for a tighter supply, higher rents, and a better valuation environment over the next three to four years.

In the beleaguered commercial office space, class A, trophy office properties appear positioned to present among the best investment opportunities in 2025. Office leasing activity has increased pushing occupancies up, however they are still being priced at a discount to industrial and multi-family assets. In the aggregate, the office sector is still distressed; with vacancy is hovering around 19%, near highs. However, there is virtually no new supply coming down the pipeline and we do expect vacancies to fall as premier assets are leased up. Outside of A-class office, lower quality assets will continue searching for a bottom, possibly into late 2025 or early 2026, as distressed investors and lenders work through underwater assets.

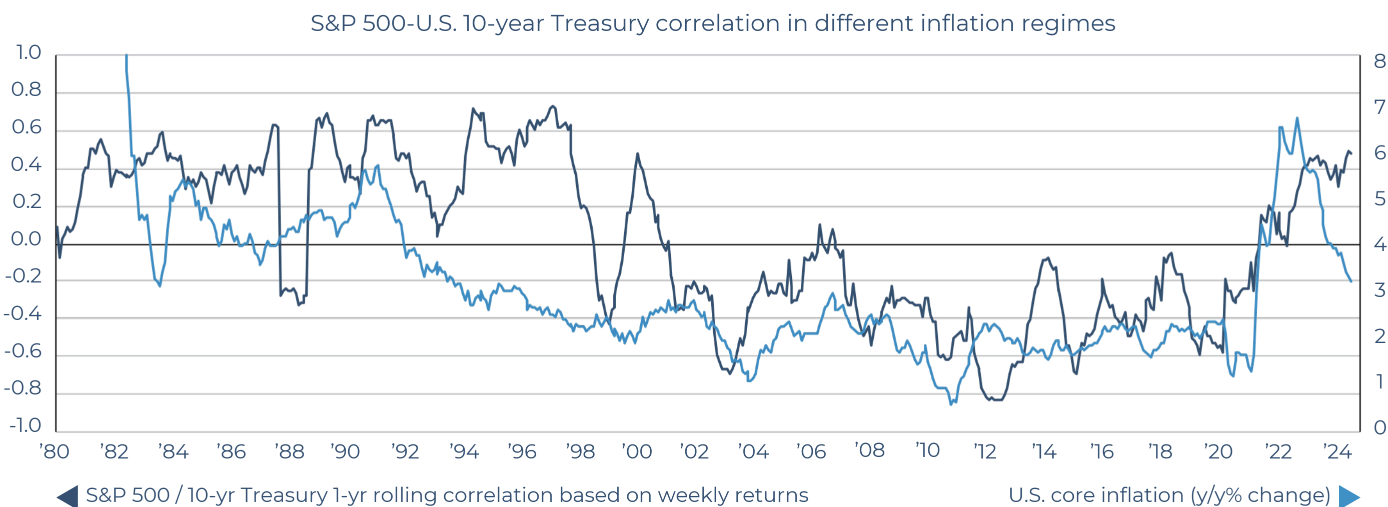
Alternatives

An Alternative Approach at Gravity's Edge:

In last year's outlook, Defying Gravity, we explored the financial markets' extraordinary resilience amid rising interest rates and macroeconomic uncertainties. Despite aggressive monetary tightening, persistent inflationary pressures, and ongoing geopolitical tensions, equity markets defied expectations, delivering consecutive annual gains of over 20% - a feat last achieved in 1995-1996. Investors defied the gravitational pull of higher rates and economic headwinds, benefiting from robust corporate earnings, technological advancements, and a surge of optimism in key sectors.

As we move into 2025, however, we find ourselves at Gravity's Edge, a critical inflection point where the forces that propelled markets higher are beginning to collide with the weight of market realities. Elevated valuations, shifting monetary policy expectations, and evolving correlations are converging to create a more challenging investment landscape. Generating returns in this environment will demand a disciplined, forward-thinking approach.

Inflation Spikes and Positive Stock-Bond Correlations have Moved in Tandem

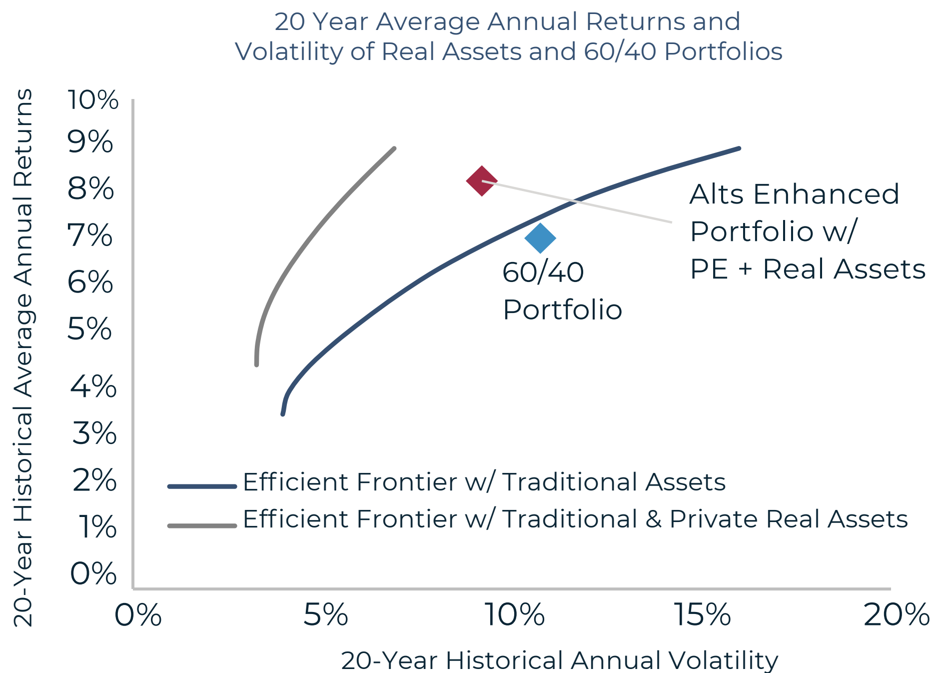


Source: BLS, LSEG Datastream, S&P Global, J.P. Morgan Asset Management; data as of August 19, 2024.

The traditional 60/40 portfolio strategy, long a cornerstone for individual investors, is now facing scrutiny as the historical relationships between asset classes are being tested. Flattening expected returns across equities and fixed income, combined with the diminishing benefits of negative correlation, signal the need for investors to go beyond conventional allocations in pursuit of meaningful diversification. The edge we now face challenges us to rethink risk, reward, and portfolio construction in a world where the benefits of excess risk-taking may no longer be as worthwhile.

To navigate this precarious environment, we believe investors must broaden their horizons. Alternative investments, such as private equity, private credit, and real assets, offer compelling opportunities to build resilience and generate sustainable returns. These asset classes, often less correlated with traditional markets, can provide diversification and reduce overall portfolio volatility.

Moreover, while rapid advancements in artificial intelligence have reshaped market valuations, with the Magnificent 7 (Mag 7) giants leading the charge. While these companies have driven much of the market's recent gains, opportunities abound in private markets to take advantage of this generational shift. By exploring these alternatives, investors can position themselves to benefit from the next wave of innovation while mitigating the growing gravitational forces within traditional markets.



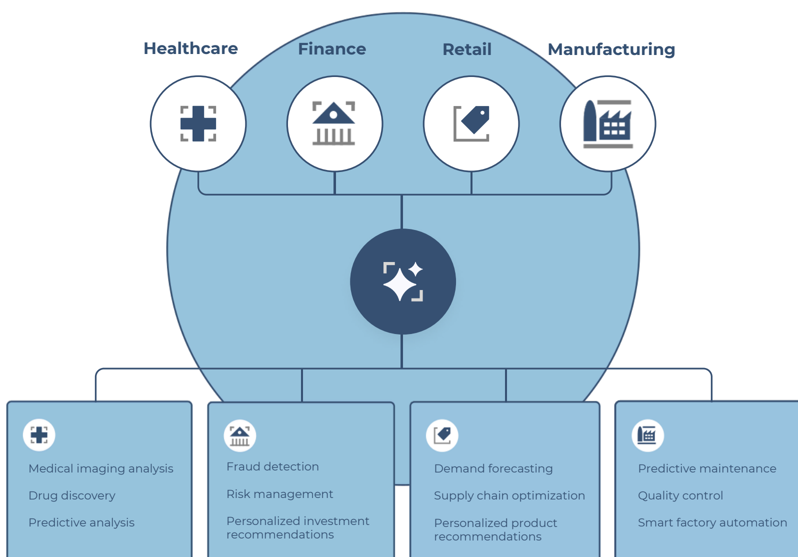
Source: KKR Global Macro, Balance Sheet & Risk Analysis. Data as at June 30, 2023.

As we've touched on several times in our outlook, we believe the revolution underway in artificial intelligence has the potential to fundamentally reshape the American economy. In roughly two years, OpenAI's ChatGPT has evolved from a novelty to a transformative force, reshaping industries and redefining the way businesses operate. This rapid evolution has spurred hundreds of billions of dollars in investments into AI infrastructure, fueling advancements in computing capabilities, data centers, and energy systems to support the growing demand for AI-driven applications.

While the headlines have gravitated toward the tech giants - companies that have committed unprecedented capital to AI infrastructure and large-scale models - there is a rising and often overlooked opportunity for innovative companies to apply AI in transformative ways across various sectors. The AI boom is no longer limited to the Mag 7 rather, it is expanding into a broader ecosystem of enterprises leveraging AI to drive operational efficiency, enhance decision-making, and revolutionize business models.

As highlighted in our core theme, *Casting a Wider Net*, the AI revolution is creating opportunities beyond the dominant tech players. Industries that have traditionally lagged in digital transformation - such as healthcare, finance, retail, and manufacturing - are now fertile ground for AI-driven efficiency improvements. The next wave of AI adoption will likely be seen in these sectors, unlocking significant value for early investors and positioning them to capitalize on this generational shift.

As we stand on *Gravity's Edge*, the path forward requires thoughtful recalibration. By embracing alternative investments, exploring private markets, and capitalizing on the transformative power of AI, investors can build resilient portfolios capable of navigating this new landscape.



Source: Inbenta

Private Equity:

Prior to 2022, private equity thrived on the tailwinds of low interest rates and multiple expansion, delivering consistently strong returns. However, the higher higher interest rate environment that emerged in recent years has reshaped the private equity playbook. Firms have had to adjust to reduced leverage as a driver of returns, placing a greater emphasis on operational improvements to create value.

In this new paradigm, successful private equity investments hinges on two key pillars: operational enhancements and selective deal sourcing. Firms must now focus on actively improving the performance of portfolio companies, leveraging tools such as advanced technology, streamlined processes, and disciplined cost management. At the same time, higher interest rates demand a sharper eye for opportunity, requiring firms to pursue deals with well-defined paths to profitability and sustainable growth.

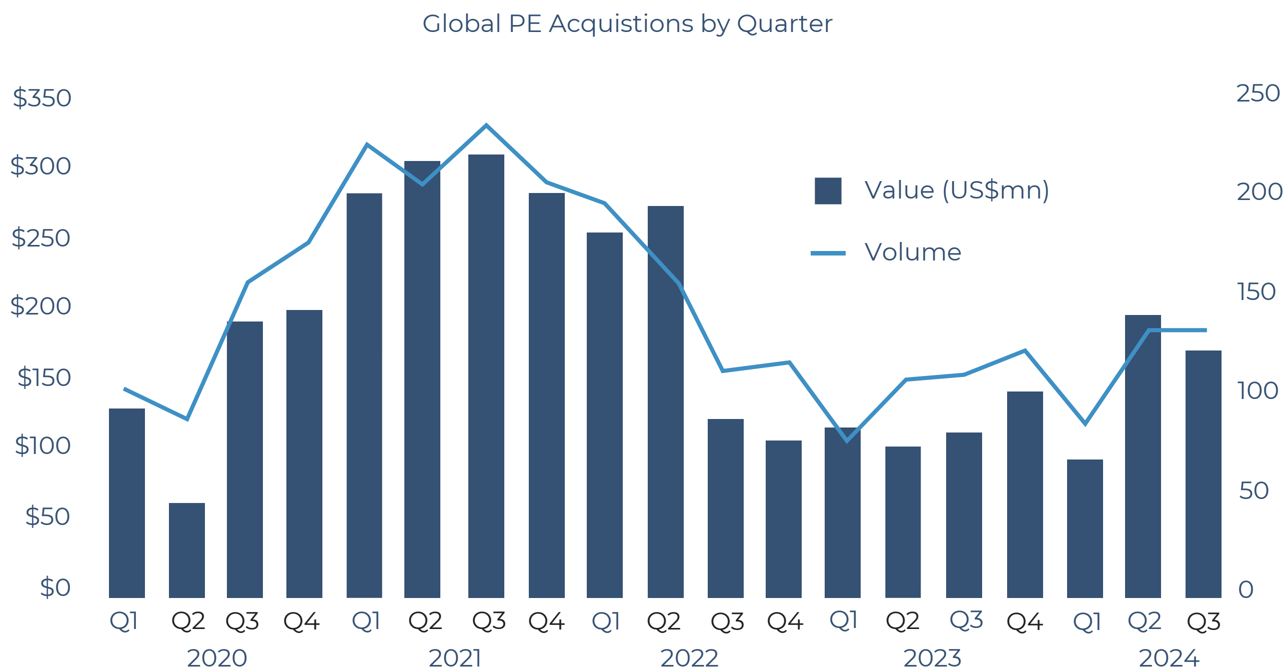
Private equity firms are finding themselves increasingly focused on growth capital investments, as many companies are choosing to remain private longer due to subdued IPO activity. Although IPOs rebounded in 2024 with activity up 39%, they remain below historical averages. This trend has created opportunities for private equity to provide essential funding to venture-backed companies needing late-stage capital to scale operations and compete effectively.

While IPOs continue to lag, mergers and acquisitions (M&A) surged in 2024, marking a 28% increase in activity. The revival of M&A signals a turning point, as private equity and corporate sponsors find renewed alignment in valuations after years of wide bid-ask spreads. This momentum in new sale activity last year is expected to carry into 2025, supported by:

- **A More Supportive Rate Environment:** With interest rate pressures easing, deal financing is likely to become more attractive, bolstering transaction volumes. This makes it easier for acquirers to price in interest rate risk which should help the spread between buyers and seller to narrow.

- **Decreased Regulatory Burdens:** Changes in government regulations, particularly under the Trump administration, have created a more favorable backdrop for corporate transactions. Increased anti-trust scrutiny under the Biden administration will likely give a more relaxed approach, which should lead the way to increased M&A activity and portfolio sales.

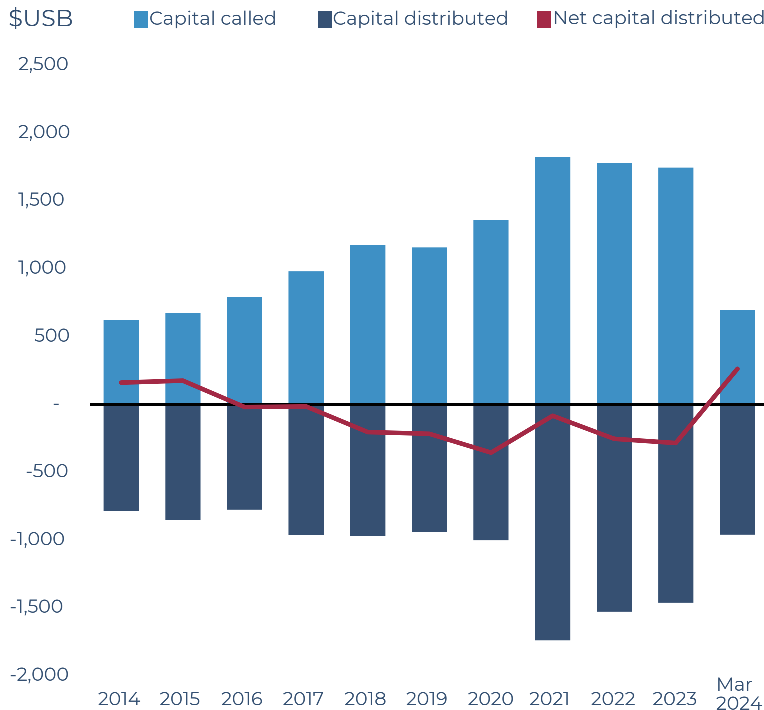
- **Corporate Carveouts and Strategic Acquisitions:** Middle-market buyouts are well-positioned to thrive in this environment as corporations seek to streamline operations and divest non-core assets.



Source: EY, Dealogic, Moonfare

One of the most significant dynamics in private equity over the past year was the shift in capital flows. For the first time in eight years, distributions to limited partners outpaced capital calls. This trend is expected to continue into 2025 as exit activity increases, improving liquidity and enabling allocators to commit capital to new private equity offerings.

Breaking 8YR Streak, Distributions Outpacing Capital Calls



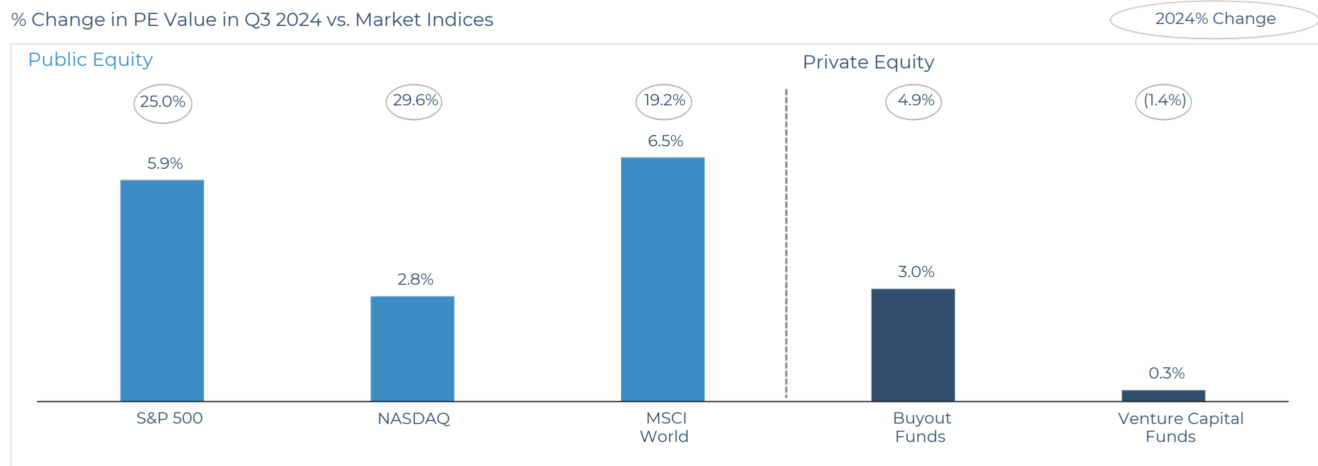
Source: BlackRock, Prequin. Data accessed on November 17, 2024

Private equity offers an attractive entry point in 2025 for several reasons. One key factor is the valuation gap between private and public markets. The average global private equity EV/EBITDA multiple stands at 12.7x, significantly lower than the 16.5x multiple for the S&P 500. This disparity creates an opportunity for private equity firms to acquire assets at more favorable valuations compared to public markets, enhancing their potential for strong returns. As the gap between private and public market valuations narrows, private equity firms are uniquely positioned to generate outsized returns by leveraging operational expertise and disciplined investment strategies.

Additionally, the middle market remains a resilient growth area within private equity. Middle-market buyouts continue to present compelling opportunities, particularly in sectors benefiting from strategic acquisitions and corporate carveouts. These dynamics allow private equity firms to unlock value through targeted investments and operational improvements, making this segment a critical focus for 2025.

There has been a widely publicized gap between public market and private market valuations over the preceding two years. However, what the conversation fails to address is the lag in private market valuations shifts. In 2024, the S&P 500 was up 25%, whereas the Buyout index only appreciated 5% through the third quarter. Assuming there are no substantial repricing events in the public market, we would expect private market valuations to catch up in 2025 to reflect more favorable economic conditions and smoother path for portfolio company growth.

Large Valuation Gap Between Public and Private Markets, Private Market Valuations Should Catch Up



Source: Neuberger Berman, Capital IQ. Includes private market data collected through December 11, 2024.

For investors seeking to navigate this environment, private equity remains a vital component of a well-diversified portfolio, offering exposure to transformative opportunities that are not yet accessible in public markets.

Private Credit:

Private credit and direct lending continue to present compelling opportunities for investors, supported by elevated interest rates and high gross yields. As of 2024, gross yields for U.S. first-lien loans stand at 10.75%, making private credit an attractive option for income-seeking investors. Unlike traditional fixed-income instruments, private credit offers a unique combination of consistent cash flows and floating rate structures that benefit from rising rates.

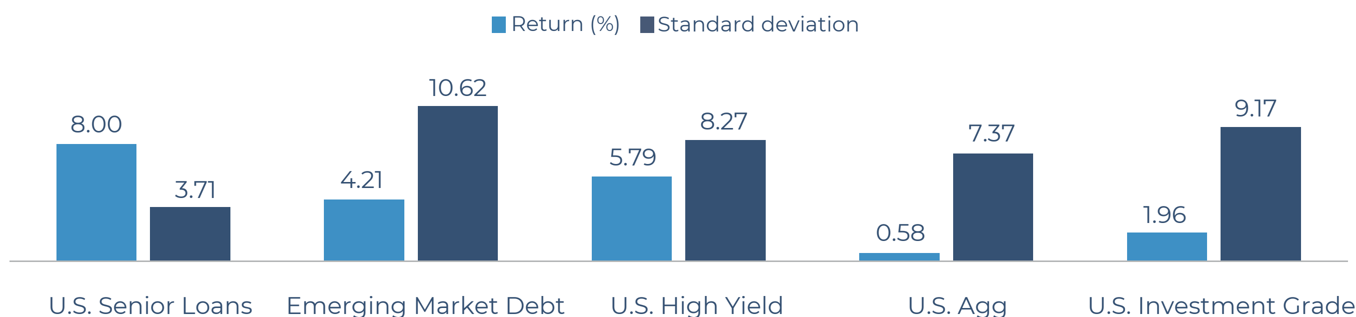
In 2024, spreads tightened as competition among lenders intensified, creating a borrower-friendly environment. However, as we move into 2025, we expect this trend to reverse, with spreads likely to widen. Factors such as higher interest rates, increased demand from acquirers, and ongoing economic uncertainty are expected to lead to more selective lending opportunities, shifting the dynamics in favor of lenders. Defaults in direct lending remain low at 1.9%, well below the long-term average of 2.9%. While modest increases in default rates are expected, recovery rates are projected to remain robust, providing a level of resilience for private credit investors.

After subdued activity in 2023, middle-market transactions have normalized, and this trend is expected to accelerate further in 2025 as M&A activity picks up. The resurgence of M&A, with a 28% increase in 2024 and further growth projected, is creating a favorable environment for private credit issuance. Middle-market companies, in particular, are driving demand for direct lending solutions to finance acquisitions, expansions, and corporate carveouts.

Private credit provides an essential source of capital to middle-market businesses and offers investors the opportunity to capture attractive risk-adjusted returns. Key benefits of private credit include:

- **Income Generation:** Elevated rates and wider spreads provide enhanced income potential relative to traditional fixed income.
- **Capital Preservation:** With lower default rates and high recovery rates, private credit offers stability even in periods of economic uncertainty.
- **Portfolio Diversification:** As an alternative asset class, private credit adds a layer of diversification, reducing overall portfolio volatility. The asset class offers meaningful protection against rising interest rates, and has performed exceptionally well during rising rate environments.

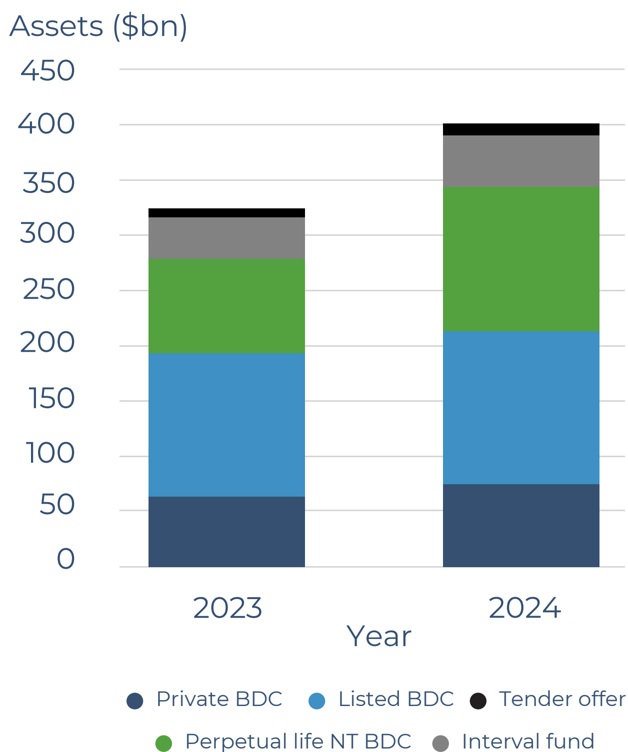
U.S. Senior Loans Outperformed During Rising Rates



Source: Nuveen, Morningstar. Time period shown is since first Fed rate hike during this cycle.

The private credit landscape has evolved significantly, offering investors more ways than ever to access this asset class. Before the Global Financial Crisis (GFC), private loans to businesses were largely held on bank balance sheets. However, over the past 16 years, Wall Street has introduced a range of innovative structures designed to provide broader access to private credit.

This democratization of private credit has opened up new opportunities for individual investors. In the U.S., private wealth vehicles such as business development companies (BDCs), interval funds, and tender offer funds have collectively raised $400 billion in assets under management, giving individuals access to private senior loans. These developments have made private credit more accessible, providing an attractive avenue for investors seeking diversification and steady income.



Source: SEC, With Intelligence

While private credit offers investors an attractive risk adjusted returns, these underlying sectors within private loans require a nuanced understanding of their respective risk profiles. It's more important now than ever to work with an experienced advisor that can employ a flexible approach to the most compelling opportunities that the private credit market offers.

As we move into 2025, private credit remains a bright spot in the alternative investment landscape. Elevated yields, a favorable M&A backdrop, and resilient market dynamics position private credit as an attractive opportunity for investors seeking both income and diversification. The combination of low defaults, high recovery rates, and a robust middle-market lending environment reinforces the strategic value of private credit in a well-rounded portfolio.

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