2025 Outlook

Q4 2024 Review and 2025 Outlook

Summary and Implications

- U.S. economic prospects continue to diverge from those of the rest of the world as the former enjoys strong domestic demand and investment spending while the latter is suffering from slowing domestic demand and trade uncertainty.
    - Investors are advised to invest with a U.S. home bias, focusing on high quality investments but also attractive valuations across small and mid caps which have lagged this past year's rally.
    - The pace of U.S. Federal Reserve easing of monetary policy is expected to slow with a resilient economy and stubborn inflation still trending above Fed policy targets. Investors should take advantage of high inflation-adjusted bond yields and investigate hard asset hedges against a risk of re-acceleration in inflation.
    - Portfolio diversification can have an even more prominent impact on investors as the market navigates the divide between slowing demand in reaction to high interest rates over the past two years and the potential reacceleration of activity despite higher-than-expected real interest rates.

Investment Summary and Outlook

U.S. stocks (primarily megacap technology growth stocks) ended 2024 on a high note, defying high earnings growth expectations embedded in multi-decade high valuations as well as uncertainty around Federal Reserve policy (hawkish to dovish back to hawkish), worldwide election drama, simmering geopolitical tension (Russia/Ukraine, Middle East conflicts), and China's varying postures toward economic stimulus. The November U.S. elections fueled a 4th quarter U.S. stock rally over prospects of lower taxes and deregulation under a new administrative regime. After having underestimated this year's market advance, few on Wall Street are ready to call an end to the rally as none of the 19 strategists tracked by Bloomberg expect a decline in the S&P 500 in 2025.

Through all the geopolitical uncertainty, the U.S. economy remains firmly in mid-cycle form as U.S. real GDP is expected to grow 2.8% for 2024 and 2.2% for 2025, well ahead of the rest of the world that is skating near recessionary territory. The keys to maintaining mid-cycle growth are 1) higher productivity (currently 2.2% annualized) as companies enjoy the pay-off from post-pandemic investments and 2) progress on disinflation that enables the Fed to maintain its rate cut schedule.

However, the combination of a more hawkish Fed (pause pivot on rate cuts), higher long-term interest rates, and looming prospects of increased tariffs would likely weigh on the more cyclically sensitive areas of the market, such as manufacturing and construction. Based on surveys from regional Fed branches and the Conference Board, there were already indications of front-loading of inventory and business spending prior to the November election due to policy uncertainty of what may follow.

US Economic Growth Seen Outpacing Rich Peers in 2024

IMF projects US economy will fare better than other G-7 countries

	Forecast for 2024 GDP	Change vs prior forecast	Forecast for 2025 GDP	Change vs prior forecast
US	2.8%	+0.2PP	2.2%	+0.3PP
Canada	1.3	0.0	2.4	0.0
France	1.1	+0.2	1.1	-0.2
UK	1.1	+0.4	1.5	0.0
Italy	0.7	0.0	0.8	-0.1
Japan	0.3	-0.4	1.1	+0.1
Germany	0.0	-0.2	0.8	-0.5

Source: International Monetary Fund — Bloomberg

At the December 2024 FOMC, the Fed cut its benchmark rate by 0.25% as expected to a range of 4.25%-4.50%, but signaled a 'pause' in the forward path of additional cuts. The Fed acknowledged that GDP growth and labor market conditions remain solid, albeit cooling in a gradual manner, but that inflation remains stubbornly above the Fed's policy target. Inflation has eased from the supply-chained induced peak levels reached in 2021-2022, but remains above the Fed's 2% target, with total Personal Consumption Expenditure (PCE) prices rising 2.5% over the past year and core PCE prices rising 2.8%. During the post-December FOMC press conference, Fed Chair Jerome Powell maintained that Fed policy remains "meaningfully restrictive" at current levels but that the Fed would move cautiously on further easing, conditioned on achieving more progress in bringing down inflation.

Region: United States » — Instrument: Fed Funds Futures »

Target Rate 4.50 — Pricing Date 12/30/2024

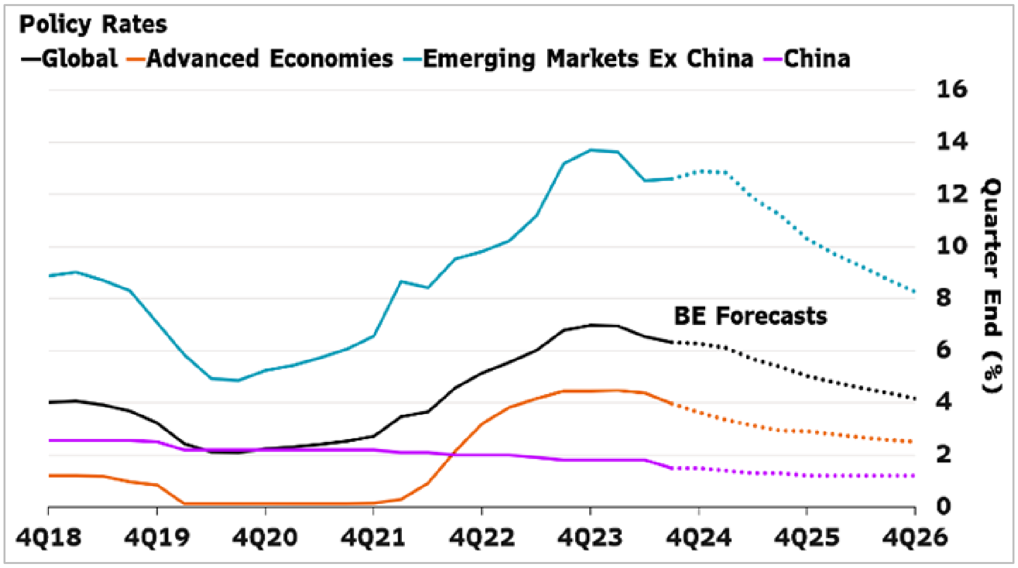
Effective Rate 4.33 — Cur. Imp. O/N Rate 4.331

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
01/29/2025	-0.112	-11.2%	-0.028	4.302	0.250
03/19/2025	-0.562	-45.0%	-0.140	4.190	0.250
05/07/2025	-0.805	-24.3%	-0.201	4.129	0.250
06/18/2025	-1.205	-40.0%	-0.301	4.029	0.250
07/30/2025	-1.352	-14.7%	-0.338	3.993	0.250
09/17/2025	-1.541	-18.9%	-0.385	3.945	0.250
10/29/2025	-1.642	-10.1%	-0.411	3.920	0.250
12/10/2025	-1.741	-9.9%	-0.435	3.895	0.250
01/28/2026	-1.762	-2.1%	-0.441	3.890	0.250
03/18/2026	-1.814	-5.2%	-0.454	3.877	0.250
04/29/2026	-1.812	+0.2%	-0.453	3.878	0.250
06/17/2026	-1.442	+37.1%	-0.360	3.970	0.250

Source: Bloomberg World Interest Rate Probability

The Fed also updated its Summary of Economic Projections (SEP) to account for lower unemployment and sticky inflation for 2025, anticipating a fed funds rate target of 3.9% by the end of 2025 (up from 3.4% in September) and 3.4% by the end of 2026 (up from 2.9%). The Fed did reiterate that the SEP is not a forecast and that future policy decisions remain data dependent. Fed funds futures are currently pricing in one to two additional 0.25% rate cuts by the end of 2025 as the bond market reset its expectations of how fast and how much the Fed is going to cut rates this cycle.

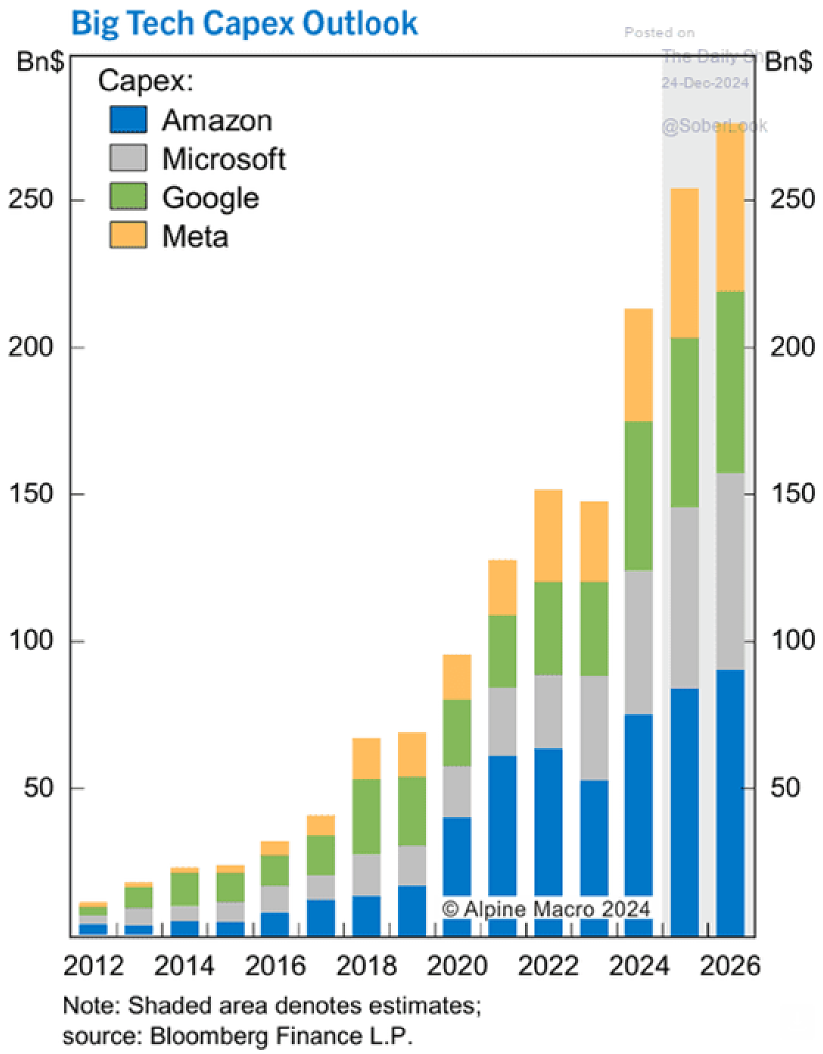
Post-pandemic disinflation has proven to be a long and uneven process as global economies de-synchronize from one another. As the Federal Reserve and Bank of England slow down their speed of easing in 2025, other central banks such as the European Central Bank are moving more quickly towards the neutral rate. For the People's Bank of China, the risk has now become deflation as the country grapples with the aftermath of its property collapse, excess manufacturing capacity, and lackluster domestic consumption despite the government's efforts to stimulate its economy through fiscal means. At the other extreme, the Bank of Japan is still raising interest rates as the country is still grappling with post-pandemic inflation. Finally, the incoming Trump Administration and its threats to impose tariffs are set to drive global rate differentials even wider in 2025, helping the surge in the U.S. dollar against trading partners.



Source: Bloomberg Economics

Over the course of the post-pandemic shutdown, the U.S. economy can be characterized as K-shaped, where the upper leg of the K is driving the reported aggregate activity, whether consumer spending or business investment. Even though real wage growth has outpaced inflation, U.S. consumption continues to be largely driven by spending from the upper income cohorts (40% of aggregate spending), who are benefiting not only from a tight labor market for skilled workers but also the wealth effect from higher asset prices as well as higher interest income as net savers benefit from higher rates.

And the outsized contribution of U.S. technology growth stocks continues to widen the capital expenditure divide as AI-hyper-scalers rush to build out energy-intensive data centers to capitalize on the exponential growth of inferences feeding into AI large language models (LLMs). This rush to build out generative artificial intelligence capabilities through data centers, to the tune of an annual spend of $300 billion by 2026, has led to a surge in demand for computer hardware and cloud computing services, and increasingly, a need for electricity production to power these energy-intensive datacenters. However, business surveys of capex intentions beyond the hyper-scalers have turned higher since the election, presumably driven by optimism over lower taxes (i.e. the extension of the 2017 tax legislation) and deregulation expected with the new administration.



Source: Alpine Macro

The global economic outlook could also be characterized as K-shaped with the U.S. and a handful of other countries (India, Southeast Asia) facing a rosier outlook than say China, Western Europe, and Latin America. Europe continues to be plagued by an uncertain electoral landscape with upcoming elections in German and France that could see further inroads from fringe parties as well as homegrown problems stemming from botched energy transitions to an overreliance on global exports to support economic growth, with the latter at even greater risk over looming U.S. tariffs. South Korea has a strong industrial base and plays a key role in the semiconductor supply chain, South Korea's economy is set to weaken next year as exports slow and the government tightens fiscal policy, not to mention a political overhang over the recent impeachment of President Yoon Suk Yeol following attempts to impose martial law. Tariffs also loom over the Americas region from Canada to Brazil, with the latter also facing political uncertainty and lower investor confidence stemming from a lack of fiscal spending restraint. In contrast, India is expected to benefit from a reshoring trend away from China, lower interest rates from central bank easing, strong harvests, and fiscal spending.

Of course, there are risks to the U.S. economic outlook besides the unknown halo effects from U.S. tariffs on global trade. The incoming Trump Administration's proposed crackdowns on net immigration and fiscal deficit spending would likely serve as a net drag on GDP growth. With respect to the latter, profligate fiscal spending is not just limited to the U.S. but global as the G-7 Nation debt load is projected to reach 180-190% of GDP by 2050 (200% projected for the U.S.). Outgoing IMF chief Claudio Borio acknowledged the exceptional status of the U.S. dollar serving as global reserve currency, but he warned that "It might take longer for the warning signs to show up, [but] the impact on the global economy [from U.S. sovereign debt risk] is bigger." European governments, such as France, are already suffering from higher borrowing costs as the market demand is insufficient to absorb the net supply of debt issuance. The upshot is that if markets perceive government borrowing as unsustainable, then these governments will likely experience a "sharp adjustment in bond yields," apart from inflation trends.

Freedom Investment Management Capital Market Projections

We enter 2025 with a higher nominal and real (inflation-adjusted) interest rate backdrop than we entered 2024 based on implied inflation expectations priced between U.S. TIPS vs nominal Treasuries. Despite the elevated real rate environment, higher interest rates did not stop consumers spending, businesses borrowing, and U.S. stocks rallying, with the latter enjoying nearly a three-point multiple expansion on forward earnings from the beginning of the year (19.7x Price/Earnings) to the end (22.3x Price/Earnings). Cash is still attractive with short-term cash vehicles yielding around 4.25% (opposed to 0% at the end of 2021), but those rates will likely drop should the Fed ease policy throughout 2025 and 2026, with short-term rates expected to drop over 1%.

Freedom believes that price matters over the long run and that what you pay today will influence the returns you realize over the long-term. Price can exert a long-term gravitational pull on expected returns. Long-term investors should remain fully invested as part of a strategic asset allocation built on risk-based investment programs. The current environment speaks to less attractive valuations across risk-based assets, namely U.S. large caps and corporate credit fixed income, with the Fed expected to continue cutting rates, albeit at a slower pace than initially expected.

What follows are a series of forecasts for long-term expected returns across various asset classes. In the spirit of Fama/French and Jeremy Siegel ("Stocks for the Long Run") from University of Pennsylvania's Wharton School, Freedom derives its long-term forecasts from valuations currently priced into equity and fixed income.

Freedom Investment Management Long-Term Equity and Fixed Income Asset Return Forecasts

1. Start with MSCI All-Country World Index (ACWI) (Global Equities) and S&P 500 (US Equities) Price/Earnings Multiple Based on Consensus Next 12-Months Earnings (12/31/2024): 18.4x and 22.3x, up from 17.6x and 19.7x last year, respectively.
2. Invert the MSCI ACWI and S&P 500 P/E multiples to arrive at an earnings yield to generate a long-term real (inflation-adjusted) return forecast: 5.4% and 4.5%, down from 6.0% and 5.1% last year, respectively.
3. Long-term inflation expectations implied by 5-year/5-year breakeven rates between U.S. Treasury Inflation Protected Securities (TIPS) versus Nominal Treasuries: 2.3% (slightly higher from last year).
4. Long-Term Expected Nominal Rate of Return for global equities: 7.7% (5.4% + 2.3%). For the S&P 500: 6.8% (4.5%+2.3%)
5. U.S. Fixed Income: Projected Yield-to-Worst on Bloomberg/Barclays US Aggregate Bond Index is 4.9% (up from 4.5% last year) and +2.3% on a long-term inflation-adjusted basis.
6. Projected Yield-to-Worst on Bloomberg/Barclays US High Yield Index: 7.4% (5.1% on an inflation-adjusted basis). S&P Global Ratings Credit Research is projecting a 3.25% default rate (base case) in 2025.

Hence, a 60/40 portfolio consisting of Global Stocks and US Investment Grade Bonds is projected to return approximately 6.6% nominal return (4.3% inflation-adjusted) over the long run based on year-end valuations. 6.0% (3.7% inflation-adjusted) for a 60/40 blended portfolio only including U.S. stocks. One can potentially increase returns by investing in riskier asset classes such as small caps and high yield, but one would also be introducing more risk into the portfolios, even when accounting for diversification benefits.

U.S. Fixed Income Markets

Index Performance as of 12/31/2024	4Q2024	YTD	1-Year	3-Year (Ann)
Bloomberg US Agg Bond TR USD	-3.06	1.25	1.25	-2.41
Bloomberg US Treasury Bill 1-3 M TR USD	1.19	5.32	5.32	3.98
Bloomberg 1-5 Yr Treasury TR USD	-0.83	3.30	3.30	0.63
Bloomberg Treasury 5-7 Yr TR USD	-3.38	0.95	0.95	-2.16
Bloomberg Treasury 7-20 Yr TR USD	-6.03	-2.35	-2.35	-6.46
Bloomberg US Treasury 20+ Yr TR USD	-9.42	-7.98	-7.98	-13.33
Bloomberg US Agency TR USD	-1.06	3.16	3.16	-0.03
Bloomberg ABS TR USD	-0.05	5.02	5.02	1.98
Bloomberg US MBS TR USD	-3.16	1.20	1.20	-2.13
ICE BofA US Corporate TR USD	-2.84	2.76	2.76	-1.98
Bloomberg US Corporate High Yield TR USD	0.17	8.19	8.19	2.92
Bloomberg US Convertible Comp TR USD	2.63	10.95	10.95	0.70
Bloomberg Municipal TR USD	-1.22	1.05	1.05	-0.55

Source: Morningstar Direct

U.S. fixed income posted negative returns in the 4th quarter to end the year with moderately positive returns. The U.S. Aggregate Bond Index dropped 3.06% for the quarter, as interest rates rose following the Fed's initial 0.50% rate cut at the September FOMC. Investors seem less convinced that the Fed will pull off a soft landing for the U.S. economy, given that there are fewer signs the economy is cooling enough for the Fed to achieve the "last mile" on reaching its inflation target.

Corporate bonds (both investment grade and high yield) outperformed the broader fixed income market as borrowing spreads narrowed further to below pre-pandemic levels. Corporate bonds continue to enjoy relatively lower borrowing costs helped by easier monetary policy combined with healthy earnings growth and profitability. Mortgage-backed securities (MBS) underperformed, primarily due to liquidity-driven spread widening that occurred in late October but has since settled down even though rate volatility picked up following the December FOMC.

Implications: High Real (Inflation-Adjusted) Rates Are Attractive as Are High Grade Bonds

Duration or Rate-Sensitivity was the main contributor to negative returns as interest rates rose to year-to-date high levels late in the 4th quarter. The 10-Year Treasury yield ended the year at 4.57%, up from 3.78% at the beginning of the 4th quarter and 3.85% at the beginning of the year. Investment grade corporates outperformed as corporate credit, especially below investment grade, continues to benefit from lower borrowing spreads, now well below pre-COVID levels. The spread between short-term and long-term borrowing rates continued to widen since the Fed cut rates at the September FOMC, as investors avoid long maturity bonds in favor of shorter maturities.

For corporate credit outperformance to continue, inflation-adjusted rates and borrowing spreads would need to drop further, below the 2010-2015 spread levels; however, inflation conditions were more benign than versus today as there was a less stimulative fiscal spending backdrop and looming threats of global tariffs. Even with sticky inflation posing as a risk to the Fed's policy objectives for cutting rates more aggressively, investors still have an opportunity to lock in moderately high real rates by extending the maturity profile of their fixed income allocation. Asset- and mortgage-backed securities also remain attractive as spreads remain wider on a relative basis as these sectors would benefit from lower rate volatility.

International Fixed Income Markets

Index Performance as of 12/31/2024	4Q2024	YTD	1-Year	3-Year (Ann)
Bloomberg Global Agg ex US TR USD	-6.84	-4.22	-4.22	-6.28
Bloomberg EuroAgg TR USD	-7.09	-3.79	-3.79	-6.03
Bloomberg Asian Pacific Agg TR USD	-6.28	-4.47	-4.47	-6.20
Bloomberg EM Local Currency USD	-7.17	-1.99	-1.99	-1.82

Source: Bloomberg

In U.S. dollar terms ("USD"), international bonds underperformed in the 4th quarter and for the year, hurt by U.S. dollar strength and higher interest rates. For the quarter. the Bloomberg Global Aggregate Bond Index (USD) and the Bloomberg EM Local Currency Index (USD) returned -6.84% and -7.17%, respectively, and -4.22% and -1.99% for the year, respectively, underperforming the U.S. Aggregate Bond Index.

Unlike the U.S., much of the world is experiencing slowing economic conditions and disinflation, prompting many central banks to ease more aggressively versus the Federal Reserve. International bonds also came under pressure from adverse political events beyond the threat of U.S. tariffs, such as the ongoing budget impasse in France, the collapse of Germany's governing coalition, lack of fiscal discipline across Latin America, notably Brazil, and the impeachment of South Korea's president following attempts to impose martial law. The 10-year government bond yields of Germany, France, the U.K., and Japan rose to 2.37%, 3.20%, 4.57%, and 1.10% at the end of the year, respectively, from 2.02%, 2.56%, 3.54%, and 0.61% at the beginning of the year.

Most major currencies depreciated against the USD in reaction to diverging economic fortunes between the U.S. and the rest of the world. Notably, the Japanese yen sharply depreciated against the USD as the Bank of Japan is reluctant to tighten policy despite higher inflation. The euro also depreciated due to slowing business activity across much of the continent. For the year, the yen dropped 11.46% against the USD while the euro and UK pound depreciated, 6.21% and 1.69%, respectively.

Implications: US Dollar Strength to Be Buttressed by the Threat of Tariffs and Diverging Growth

Barring a renewed upturn in inflation, the path for lower U.S. rates into 2025-26 should remain in place, even at a slower pace in the face of a resilient U.S. economy and sticky inflation. Slowing economic conditions and progress on inflation could pressure the U.S. dollar, but this does not represent the base case scenario, as U.S. economic fortunes diverge from those of the rest of the world, especially China. Geopolitical uncertainty and political drama will likely remain overhangs in 2025, starting with German elections in February.

Last quarter, we recommended investors with outsized foreign currency exposure consider locking in 3rd quarter gains from dollar depreciation. In light of the November election and its policy implications such as more fiscal stimulus to support growth and the threat of tariffs, investors should continue to hedge to the USD or allocate to U.S.-based fixed income. China fiscal and monetary stimulus would likely flow through other trade-heavy economies that rely on weaker currencies to maintain export competitiveness.

U.S. Equity Markets

Index Performance as of 12/31/2024	4Q2024	YTD	1-Year	3-Year (Ann)
S&P 500 TR USD	2.41	25.02	25.02	8.94
Russell 1000 Growth TR USD	7.07	33.36	33.36	10.47
Russell 1000 Value TR USD	-1.98	14.37	14.37	5.63
Russell Mid Cap Growth TR USD	8.14	22.10	22.10	4.04
Russell Mid Cap TR USD	0.62	15.34	15.34	3.79
Russell Mid Cap Value TR USD	-1.75	13.07	13.07	3.88
Russell 2000 Growth TR USD	1.70	15.15	15.15	0.21
Russell 2000 TR USD	0.33	11.54	11.54	1.24
Russell 2000 Value TR USD	-1.06	8.05	8.05	1.94
S&P Cmmncton Svces Select Sector TR USD	7.34	34.79	34.79	8.75
S&P Cons Staples Select Sector TR USD	-4.63	12.34	12.34	3.44
S&P Consumer Disc Select Sector TR USD	12.14	26.62	26.62	4.12
S&P Energy Select Sector TR USD	-1.63	5.65	5.65	20.01
S&P Financial Select Sector TR USD	7.09	30.56	30.56	9.42
S&P Health Care Select Sector TR USD	-10.30	2.58	2.58	0.87
S&P Industrial Select Sector TR USD	-2.27	17.47	17.47	9.47
S&P Materials Select Sector TR USD	-12.29	0.21	0.21	-0.35
S&P Real Estate Select Sector TR USD	-7.94	5.23	5.23	-4.41
S&P Technology Select Sector TR USD	3.14	21.74	21.74	11.21
S&P Utilities Select Sector TR USD	-5.51	23.43	23.43	5.22
S&P 500 Dividend Aristocrats TR USD	-6.22	7.08	7.08	2.89
S&P 500 Low Volatility TR USD	-1.97	14.26	14.26	3.16
S&P 500 High Beta TR USD	-0.49	8.74	8.74	5.00
S&P 500 Momentum TR USD	4.97	46.01	46.01	15.45
S&P 500 Quality TR USD	-0.09	25.70	25.70	9.85
DJ US Select Dividend TR USD	-1.85	16.62	16.62	6.60

Source: Morningstar Direct

U.S. equities continued their strong 2024 advance following the November elections and positive technology developments out of the Mag7 megacap companies. For the quarter, the S&P 500 returned 2.41%, narrowly driven by a handful of megacap technology stocks, while the Russell Mid Cap and Russell 2000 returned 0.62% and 0.33% respectively, with large return differentials between growth and value stocks. For the year, the S&P 500 returned 25.02%, as growth significantly outperformed value for much of the year, while the Russell Mid-Cap and Russell 2000 lagged the S&P, returning 15.34% and 11.54%, respectively. Communication Services, Consumer Discretionary, and Technology were the only sectors to post positive 4th quarter returns as the Mag7 stocks dominate the sector weightings.

Since the launch of ChatGPT in November 2022, the bullish narrative of generative artificial intelligence and other technology advances across cryptocurrency, space exploration, and quantum computing have been enough to propel U.S. stocks beyond what many sell-side strategists had forecasted at the beginning of 2024. The top 10 largest stocks in the S&P 500 have accounted for 59% of the index's gain since the October 2022 bottom, and the largest 20 stocks 70% of the gain. This has been a very narrow market advance, lacking broader participation, that some strategists warn indicates an unhealthy market, akin to the Nifty 50 rise and collapse in the early 1970s.

Following a flat year for overall S&P earnings growth in 2023 and sub-10% growth in 2024, the earnings outlook for 2025 looks rosier with sell-side analysts expecting +15% earnings growth for S&P 500 companies. Valuations and geopolitical uncertainty aside, investors continue to give the benefit of the doubt to U.S. large cap equities, even as they shy away from taking on more fixed income risk. Equity market valuations continue to be driven by earnings and as long as the 'E' of P/E continues to grow, so likely will the 'P.' Ahead of the 4th quarter earnings releases, the consensus outlook for S&P 500 company earnings growth is for 9.4% in CY-2024 and 14.8% in CY-2025, with the so-called Mag7 expected to grow earnings in 2025 by 21% versus 13% for the rest of the S&P. Analysts also expect corporate profit margins to reach 13%, the highest level in 10 years, due to a combination of pricing power and productivity. With the S&P trading near 23x forward 12-month earnings, market valuations leave little room for error, but the equity outlook looks bright should the expected earnings growth come to fruition.

Implications: Stick with High Quality and Value, Diversify Away from Mag7 and Into Small and Mid-Caps, and Hedge Reacceleration Risk with Hard Assets

U.S. equity leadership in the form of market valuation and profitability, especially the Mag7, is well recognized by global investors as the U.S. share of worldwide market capitalization has risen to nearly 70%. The valuation gap between large cap growth and small cap value also remains historically wide with the former trading at 13.7x price/book versus 1.3x price/book for the latter.

Will the earnings picture broaden beyond the tech-thematic segments? This remains the key to narrowing the performance gap between large and small caps and growth and value stocks as investors continue to discriminate between the winners and. A broadening of breadth can reward portfolio diversification as well as encourage fundamentally driven price discovery beyond the thematic technology narratives.

Although Freedom anticipates that we are more likely in the mid-cycle rather than late cycle phase of the post-pandemic period, we continue to favor U.S. stocks with strong balance sheets and durable profitability trading at reasonable valuations, especially in the mid and small cap market segments. We do remain neutral on relative positioning between large and small caps and value and growth stocks but see opportunities to allocate to many lagging areas of the market, such as cyclicals and defensives. We also advise investors to investigate hard asset plays across natural resources and real estate as a potential hedge against inflation reacceleration risk with global central banks still committed to an easing of monetary policy despite sticky inflationary pressures.

International Equity Markets

Index Performance as of 12/31/2024	4Q2024	YTD	1-Year	3-Year (Ann)
MSCI ACWI NR USD	-0.99	17.49	17.49	5.44
MSCI ACWI Ex USA NR USD	-7.60	5.53	5.53	0.82
MSCI ACWI Ex USA Growth NR USD	-7.88	5.07	5.07	-2.67
MSCI ACWI Ex USA Value NR USD	-7.31	6.04	6.04	4.37
MSCI ACWI Ex USA Mid Growth NR USD	-7.32	3.39	3.39	-3.74
MSCI ACWI Ex USA Mid NR USD	-7.43	3.58	3.58	-0.95
MSCI ACWI Ex USA Mid Value NR USD	-7.53	3.72	3.72	1.85
MSCI ACWI Ex USA Small Growth NR USD	-7.23	3.13	3.13	-4.55
MSCI ACWI Ex USA Small NR USD	-7.66	3.36	3.36	-1.47
MSCI ACWI Ex USA Small Value NR USD	-8.08	3.60	3.60	1.60
MSCI China NR USD	-7.67	19.42	19.42	-6.10
S&P Japan BMI NR USD	-4.14	7.34	7.34	2.44
MSCI AC Asia NR USD	-6.20	10.63	10.63	0.01
MSCI Europe NR USD	-9.74	1.79	1.79	1.20
MSCI EM NR USD	-8.01	7.50	7.50	-1.92

Source: Morningstar Direct

In USD terms, international equities underperformed the U.S. market in the 4th quarter as well as for the year, hurt by U.S. dollar strength and increased signs of slowing economies outside of the U.S. The MSCI All-Country World ex-USA Index (ACWI Ex USA) returned -7.60% for the quarter and 5.53% for the year, underperforming the U.S. market. International equity underperformance was largely driven by China over disappointments of fiscal stimulus to address its economic malaise, as well as broader Europe due to slowing economic conditions and political uncertainty. Latin America also lagged over looming threat of U.S. tariffs and concerns over Brazil's fiscal spending. Small caps performed in line with large caps and value performed in line with growth.

As with the U.S. market, international markets also experienced narrow breadth as a handful of tech-focused sectors, such as semiconductors, were the standout performers benefiting from global data center buildouts to process artificial intelligence applications.

Implications: Questionable Sustainability of China's Recovery and Renewed Concerns Over Trade Protectionism and Slowing Economic Activity Support Maintaining a U.S. Home Bias

Global markets continue to be valued at a discount to the U.S. with developed markets, as proxied by MSCI EAFE Index, and emerging markets, as proxied by MSCI EM Index, trading at 14.1x and 13.7x forward 12-month earnings, respectively. Earlier in the year, investors had been hopeful that international growth prospects and profitability were looking brighter, notably in Japan and broader Asia. But unlike the U.S., much of the rest of the world lacks robust internal demand to fuel domestic consumption and so must rely on industrialization and exports to generate marginal growth.

Attractive valuations offset by lackluster profitability keep us neutral on regional allocations, as investors maintain a watchful eye on the sustainability of China's financial recovery and whether global central banks outpace the Fed on easing monetary policy, putting downward pressure on their currencies versus the U.S. dollar. As with the U.S. market, we emphasize positioning in high quality stocks trading at reasonable valuations, despite the macroeconomic headwinds facing international markets.

Conclusion

As we enter 2025, the interplay between elevated valuations, shifting monetary policies, and geopolitical uncertainties underscores the necessity of disciplined, strategic investment. The robust performance of U.S. equities, led by megacap technology growth stocks, highlights the importance of maintaining a long-term perspective even amid fluctuating economic conditions. While the Fed's cautious stance on easing, coupled with persistent inflation, presents challenges, it also offers opportunities for those with a clear, forward-looking strategy.

Investors should prioritize strategic asset allocation rooted in risk-based investment programs. Remaining fully invested, rather than attempting to time market movements, allows for the long-term compounding of returns while mitigating the risks associated with short-term volatility. Freedom emphasizes the gravitational pull of valuations on long-term returns, reinforcing the need to consider price as a critical factor in decision-making.

In the fixed-income space, the current environment of high real rates presents an attractive opportunity to secure stable returns by extending the maturity profile of fixed-income allocations. Investors should also explore the benefits of diversifying into asset- and mortgage-backed securities, which remain well-positioned to capitalize on reduced rate volatility. International bonds, while currently under pressure, warrant attention for their potential to enhance portfolio diversification as global conditions stabilize.

Looking ahead, geopolitical dynamics, economic shifts, and policy developments will continue to shape market performance. With the U.S. and select global economies demonstrating resilience, investors must focus on maintaining a diversified portfolio tailored to their risk tolerance and long-term goals. The challenges of sticky inflation, potential tariff impacts, and evolving central bank policies reinforce the need for vigilance and adaptability in portfolio management.

Now more than ever, it is imperative for investors to remain committed to their strategic frameworks, leveraging insights from current market valuations and economic projections to optimize returns. By staying the course and adhering to a disciplined investment approach, investors can navigate the complexities of today's markets and position themselves for sustained success over the long term.

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Except as otherwise specifically stated, all information and portfolio manager commentary are as of January 6, 2025.

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