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MACROCOSM

Predictions for 2025: Macro and Markets

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Another good year in the post-pandemic productivity-led boom. Valuation is the only issue.

First, something really important. It's 2025. 20 + 25 is 45. 2025 is 45 squared. 2025 is the square of the sum of all ten digits from zero to nine. 2025 is the sum of the cubes of all ten digits. Thanks, Scott Grannis.

- *This is going to be short and sweet and very general. Starting tomorrow, with tariffs, we'll cover in great detail what we consider to be the decisive issues we'll face in 2025*.

Let us say at the outset that we love the year-end ritual of looking back and scoring our hits and our misses (see "Our Predictions in This Most Unpredictable Year" December 27, 2024). Any time is a good time for self-examination and self-improvement. We don't love so much the obligatory ritual a few days later of making predictions for the new calendar year. We're in the prediction business 7 by 365 anyway, and we bridle at the artificial constraint of having to make calls for an arbitrary 12-month horizon. But it's expected, and it's good discipline we suppose, so here goes.

THE BUSINESS CYCLE We're in what amounts to a post-war boom, a productivity-led expansion in the wake of an historically unique high-speed depression experienced during the pandemic. The advent of consumer-accessible artificial intelligence is an accelerant to what was already a most growth-favorable backdrop. We have stood against a relentless recession narrative for almost three years, ever since the yield curve inverted and gave a terribly false signal, and we're still there. A surge in small business confidence following Donald J. Trump's decisive election will support continued expansion at the grass roots of "animal spirits" (see "The Trump Effect" December 11, 2024). We don't think possible tariffs from the Trump administration will make any difference one way or the other (see "Predictions for 2025: Tariffs" January 3, 2025). *There's no reason to expect a recession until there's a reason to expect a recession, and right now there isn't one*.

INFLATION The crippling inflation that followed from excessive pandemic stimulus spending has run its course, and now has to find a new natural level in this post-pandemic boom. The money supply is no longer contracting, but rather growing at what would be regarded historically as a modest rate. There is no reason whatsoever to expect a resurgence of inflation like we saw in the late 1970s after it seemed, falsely, that inflation

Update to strategic view

US MACRO, FEDERAL RESERVE, US STOCKS, US BONDS, OIL: We're in a post-pandemic productivity-led boom, accelerated by the advent of consumer-accessible artificial intelligence. There is no reason to expect a recession until there is a reason, and right now there is no reason. Tariffs won't make any difference. Inflation will not resurge as the Fed eases, but will linger somewhat above target. Market expectations for two Fed rate cuts are about right, consistent with a higher neutral rate in a productivity-led boom. Stocks will perform well, but it will be hard to match the prior two years' performance given present valuations. Overweight relatively undervalued winners from the deregulation that will come quickly and easily once Trump is in office: small cap, banking and energy. Long-term yields won't see 4% again, and will likely see 5% – consistent with a productivity-led boom. Oil is well supplied globally; supply will increase with deregulation, but so will demand.

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was conquered. *We expect low and stable inflation, but likely somewhat above the Fed's official target* (see "Has the Economy Become Inflation-Prone?" October 9, 2024).

THE FED *Market expectations and Fed "dot plot" guidance for two rate cuts in 2025 is about right*, especially if we are correct that inflation will linger a bit above the Fed's target. Separately, and pointing the same direction, the Fed appears to be pre-positioning for inflationary effects of Trumponomics (again, see "Predictions for 2025: Tariffs"). We think two rate cuts is well within the range of appropriate policy given the higher neutral rate that would be consistent with a productivity-led boom.

US STOCKS *We see a very bullish economic backdrop and have no reason not to expect another year of positive returns for equities*, but we have to acknowledge that *returns will be limited versus the two fabulous prior years by the extent to which that environment is already discounted by relatively high forward price/earnings ratios*. That said, the upgrade rate of forward earnings continues to be stellar, at about twice the historical average. The equity risk premium, at about zero, is where it was, on average, during the 1980s and 1990s, which were the best decades in history for stock market total returns. To be sure, P/Es were lower then. But competing long-term Treasury yields were higher. One way to square that circle is to *overweight relatively undervalued sectors likely to get the most advantage from the deregulatory initiatives that can quickly and easily be implemented by the incoming Trump administration: small cap, banks, and energy* (see "Trump's TrendMacro Cabinet" November 25, 2024).

US BONDS If we are in a post-pandemic productivity-led boom, we have to take the over on long term yields. Without a recession (and, again, we don't think there will be a recession), *we won't see 10-year Treasuries at 4% this year. We will see them at 5% and more*. This will produce anxiety. It will all be fine. It will reflect growth expectations.

OIL The global crude market is well supplied, and supply will only increase in response to the Trump administration's deregulatory initiatives. But those initiatives will improve demand at the same time. *We are going to stick with our predicted range for Brent from $60 to $80*, but at the same time we emphasize that the removal of the regulatory tax-wedge will enable sector profit growth without higher unit prices (see "Oil Under Trump: War and Peace, but Mostly Deregulation" November 20, 2024).

Bottom line

We're in a post-pandemic productivity-led boom, accelerated by the advent of consumer-accessible artificial intelligence. There is no reason to expect a recession until there is a reason, and right now there is no reason. Tariffs won't make any difference. Inflation will not resurge as the Fed eases, but will linger somewhat above target. Market expectations for two Fed rate cuts are about right, consistent with a higher neutral rate in a productivity-led boom. Stocks will perform well, but it will be hard to match the prior two

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years' performance given present valuations. Overweight relatively undervalued winners from the deregulation that will come quickly and easily once Trump is in office: small cap, banking and energy. Long-term yields won't see 4% again, and will likely see 5% – consistent with a productivity-led boom. Oil is well supplied globally; supply will increase with deregulation, but so will demand.