Quarterly Economic Update

December 11, 2024

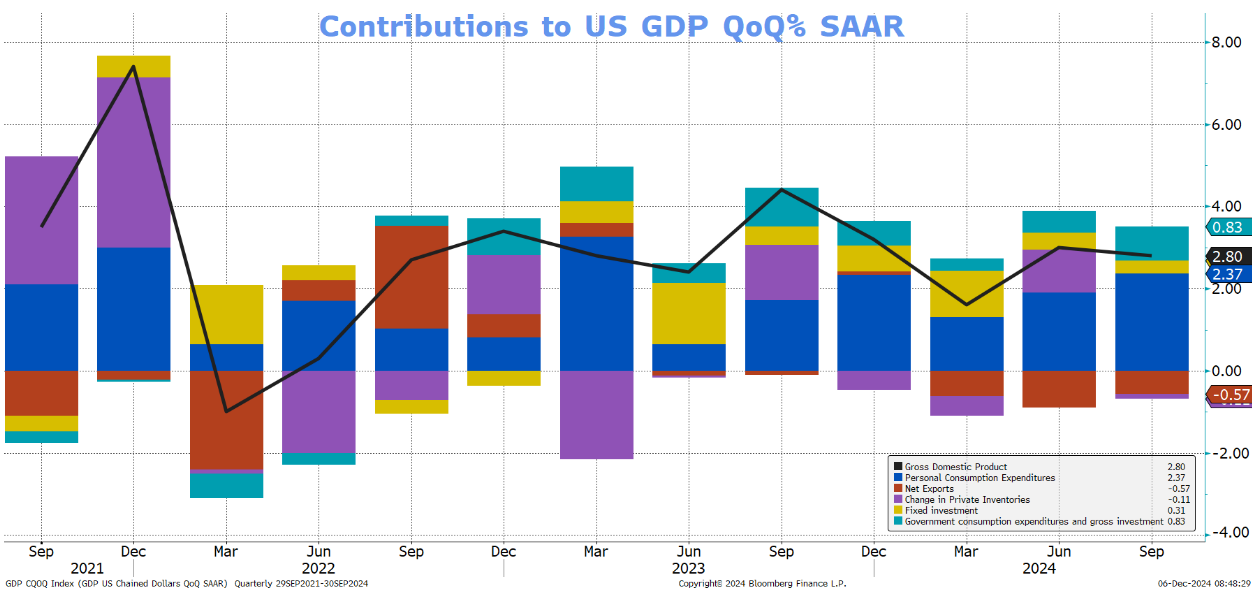
MACROECONOMIC COMMENTARY

Economic Outlook

By Bobby Long

Economic activity has continued to expand over the past several quarters, employment has remained healthy, and inflationary pressures have diminished. Some conditions have strengthened, and some have slowed, but this can be the simple ebb and flow of activity within a still expanding economy. Weaker data could signal slowing conditions or could simply be weaker data amongst a broader supportive backdrop. At this point, weaker data appears more reflective of waning strength in a maturing cycle versus a material deterioration in overall conditions. Economic activity may expand at a slower pace, but we do not see any reason growth within the supportive underlying conditions cannot continue over the next several quarters.

The most recent Gross Domestic Product (GDP) release displayed an economy that continues to generate a healthy level of growth, supported by robust consumer spending and government expenditures. Real GDP for the third quarter grew at an annual rate of 2.8%. This followed a second quarter that grew 3% after a weaker start to the year.



Strong consumer spending has been the backbone of this economic expansion. Personal consumption expenditures (PCE) grew 3.5% over the prior quarter. Higher spending on both goods and services contributed to the growth. With consumers having expressed a preference towards services, a pickup in spending across durable and nondurable goods categories was a positive shift. Durable goods spending grew 7.6% over the prior quarter. Nondurable goods spending increased 4.6%. Spending on services was also spread across categories and increased 2.6%. Government spending and investment increased 5% over the quarter, driven largely by a 13.9% rise in national defense spending. Private fixed investment grew a modest 1.1% in the third quarter with stronger investment in transportation and information processing equipment. Residential and nonresidential structures investment declined -5% and -4.7%.

The most recent personal spending data indicated slower spending growth for the month of October. Spending still increased, but at a more moderate pace following a strong September that benefited from an uptick in core goods. The table on the right provides a breakdown of the month over month changes. The strength in motor vehicle spending did not carry forward from September and home furnishings declined for the month. The other nondurables category also swung negative following a big gain the prior month. There is likely some noise in the data due to storm-related disruptions, so November data will provide more color on spending trends.

Real PCE Spending MoM%

	10/31/2024	9/30/2024	8/31/2024
Headline	**0.12**	**0.47**	**0.08**
ex Food and Energy	**0.17**	**0.46**	**0.13**
Core Goods	0.03	1.12	-0.42
Motor vehicles	0.10	1.68	-2.35
Home furnishings	-0.23	0.68	-0.23
Recreational goods	0.81	1.21	0.18
Other durables	0.47	0.34	0.74
Apparel	0.80	-0.16	-1.21
Other nondurables	-0.59	2.01	0.33
Core Services	0.22	0.19	0.29
Housing	-0.06	0.06	0.21
Health care	0.42	0.47	0.53
Transportation	-0.12	-1.02	0.81
Recreation	-0.10	-0.08	0.60
Food svcs	0.33	0.66	0.23
Financial Svc	0.11	0.33	0.74
Other Svc	0.04	-0.16	-0.14

Source: Wolfe Research, Haver Analytics, as of Oct 31, 2024

With the Thanksgiving holiday behind us, we are now in the onslaught of the holiday spending season. According to surveys from Morgan Stanley Research, consumers in aggregate intend to spend more money on holiday shopping this year. Overall, 35% expect to spend more than last year, 37% of consumers are planning to keep their holiday budgets roughly the same, and 22% expect to spend less. Higher prices due to inflation is one of the main reasons these consumers expect to spend more, but 45% indicated they plan to buy more gifts this year and 31% said higher incomes were providing a larger holiday budget. The higher spending intentions were skewed toward upper income brackets, with a net 24% of high-income households spending more versus only 7% of low-income households. This should be expected as the high-income households have a larger share of disposable income. So far, holiday sales appear to be healthy amongst heavy discounting by retailers.

Consumer spending has been supported from the higher income households. These households have disproportionally benefited as financial markets and home prices have risen, boosting net worth and their capacity to spend. These dynamics have created a wealth effect that enables households to allocate less of their income toward savings and more towards spending. Wage gains have also improved some after lagging lower income wages over the past few years. Lower income households are still in decent shape, but have felt a larger impact from inflation that has left them with less disposable income. Higher interest rates have consumed a larger percentage of household budgets as debt service costs have risen. This has impacted spending on big-ticket items that are more likely to be financed, but has been more pronounced on lower income households who carry a higher exposure to variable rate debt. Lower interest rates on revolving debt are relieving some pressure and a continued decline would support spending capacity. Credit availability has eased somewhat but remains tighter for weaker borrowers.

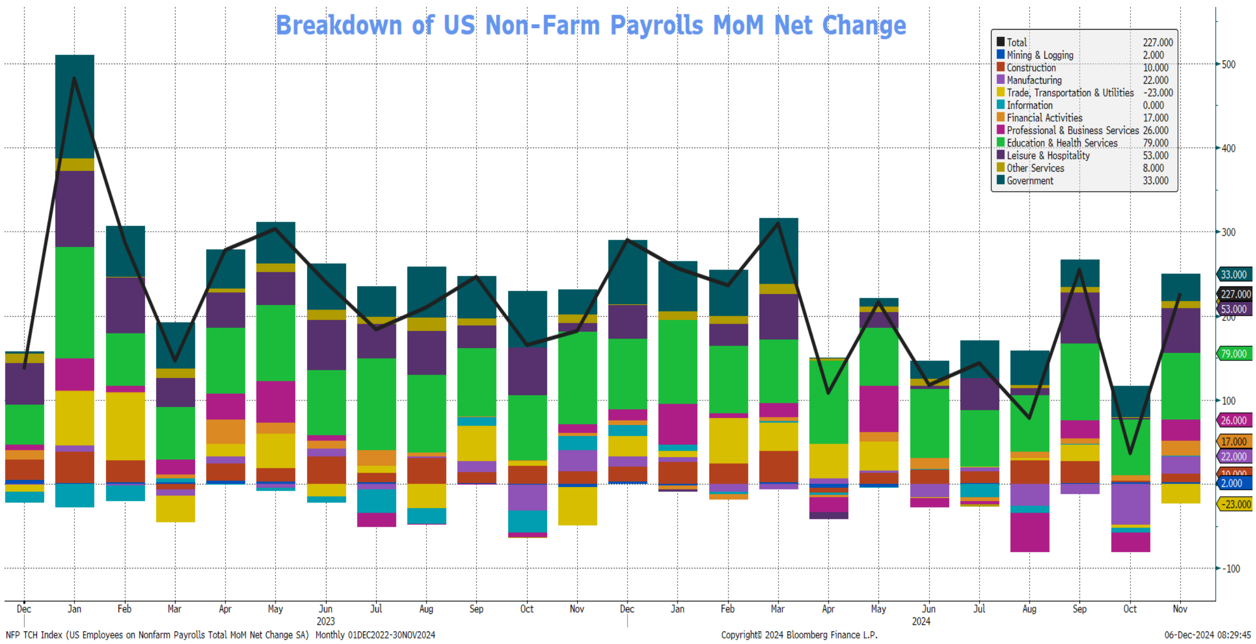
Delinquencies have been ticking higher with credit card and auto delinquencies at more elevated levels, however the sharp rise in credit card delinquencies has stabilized recently. This most likely reflects a consumer who is modestly extended and will likely have to make more conscious spending decisions moving forward. Recent anecdotes and data from retailers have shown increasing price sensitivity from consumers that are looking for discounts. As long as employment and financial markets stay strong, we believe consumer spending can remain supportive albeit at a slower pace.

The Institute of Supply Management's Manufacturing Purchasing Managers Index has not been a reliable indicator in recent years, however it is one we still watch given a decisive break one way or the other would likely provide a strong signal for broader activity. Despite economic strength elsewhere across the economy, manufacturing has remained weak with the indicator trending directionless in contraction territory for an extended period. The most recent November reading moved back higher to 48.4, still below the 50 level indicating activity is contracting, but a solid increase from the prior month.

Regional Fed manufacturing surveys have also been moving higher more recently with a composite measure having now moved above 50. This improvement combined with several of the leading manufacturing PMI components moving higher may offer some promise. A sustainable shift in manufacturing activity would be an important tailwind for broader conditions. Uncertainty around U.S. tariff policy and trade relationships remain a risk that will likely weigh on activity until more clarity is provided.

Business investment could strengthen now that the election is behind us and managements have more confidence in the path of future policy. While still low and below pre-pandemic levels, small business confidence has improved more recently. CEO confidence was weaker through the third quarter. Increased clarity in the path of future policy and potential deregulation could provide a boost to confidence and spur managements to move forward with spending plans that may have been on hold. Several business tax provisions that had already begun to sunset or were set to end in 2025 are now more likely to be extended under the new administration. This could be a source of pent-up business investment. Lower interest rates and tamer inflationary pressures would further improve confidence. Tariffs remain a source of uncertainty that could make CEOs hesitant to move forward with certain investment decisions, but policy could also shift some investment back within U.S. borders.

Labor conditions remain supportive, but job growth has been slowing. We saw weaker job gains through the summer months. September nonfarm payrolls rebounded to a healthier level of 223,000 net additions. October fell to a mere 12,000 additions, however this was impacted by hurricane-related disruptions and labor strikes. The October report did include an increase in job losses in the professional and business services sector, as well as some job losses in the manufacturing sector. November payrolls bounced back to 227,000 additions and saw an upward revision of 56,000 to the prior two-month payrolls. The stronger month paired with September's gain helps alleviate some concerns about weaker labor trends.



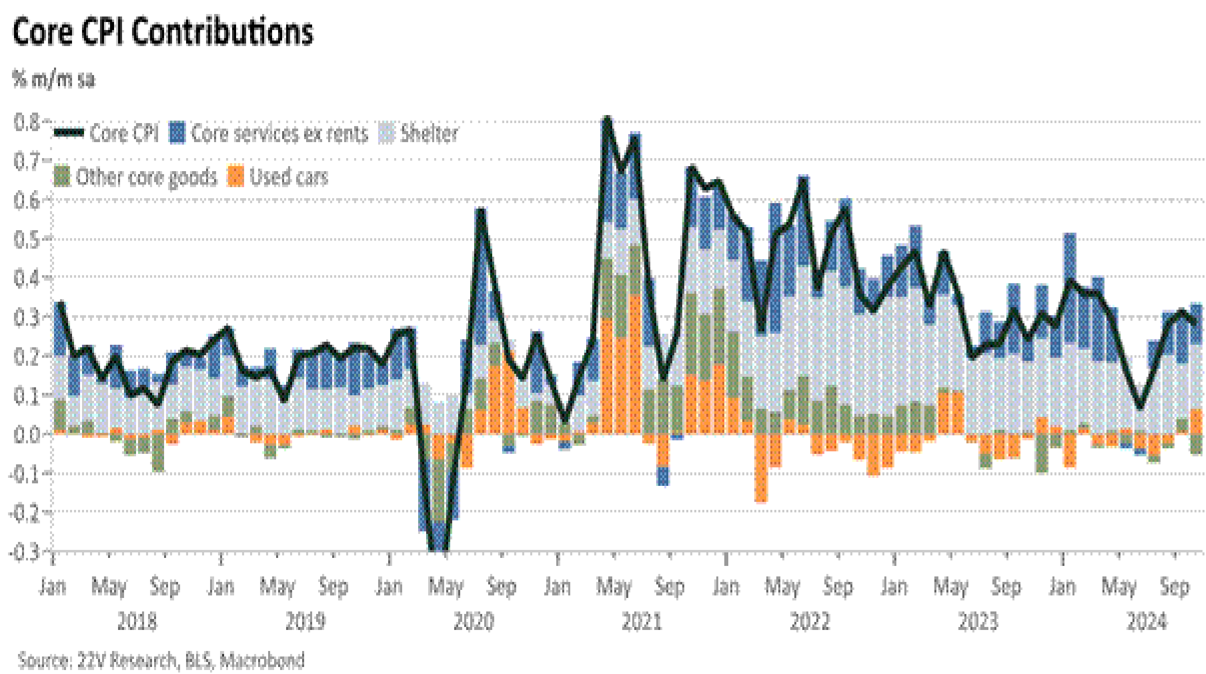
The ADP Employment Report has followed a similar path to nonfarm payrolls, weaker through the summer months and picking back up more recently. November ADP employment reported 146,000 job additions. Both surveys show net employment gains, but generally at a slower pace than the prior two years. ADP small business payrolls have been trending weaker, reporting a net 17,000 job losses for November.

The JOLTS data has continued to show job openings moving lower. Hiring has also trended lower along with the quits rate. Layoffs have modestly increased. Altogether, this confirms previously tight labor conditions have been loosening and signals a more balanced labor market. This is positive for wage pressures, but further weakness from this data could become a negative signal.

The November unemployment rate slightly increased to 4.2% but continues to run at very low levels. Initial jobless claims have been stable and remain low with the most recent 4-week average at 218,250. Continuing claims have been inching higher with 1,871,000 claims filed over the most recent week. This is still a low level, but worth watching the trend as it signals those losing jobs are having a more difficult time finding new employment.

We have seen some layoff announcements, but they have not been widespread or collectively risen to more alarming levels. The most recent Challenger Report recorded 57,727 job cuts announced by U.S.-based employers in the month of November. For the year through November, companies have announced a total of 722,566 job cuts, which is an increase of 5.2% through the same time period last year. November job cuts came largely from the automotive and manufacturing industries. The technology sector has announced the highest number of layoffs year to date.

Inflation has been slowly trending lower over the past two years. The path has not been a straight line and remains at elevated levels above the Federal Reserve's 2% target. For the month of October, the Personal Consumption Expenditure (PCE) Price Index was 2.3% on a year over year basis and core PCE was 2.8%. The Consumer Price Index (CPI) registered 2.6% for the month and core CPI excluding food and energy was 3.3%. Monthly inflation has been ticking higher more recently off lower levels earlier this year, raising concern that the progress made over the past couple of years is stalling and threatening to reaccelerate. The chart below illustrates the longer-term trend of monthly core CPI inflation and highlights a few of the more volatile and stubborn components.



The longer-term trend is still intact, however the increase in these stubborn components is raising concern that there is some embedded inflationary pressures that have not been tamed. Shelter inflation is proving more persistent. Services inflation has also been sticky and is moving higher again. Used car prices have been volatile and turned up sharply last month. Some of this could be storm related, but that only appears to be part of the story. As inventories rebalance early next year, this should see some relief. Other core goods inflation has also been volatile but is probably temporary.

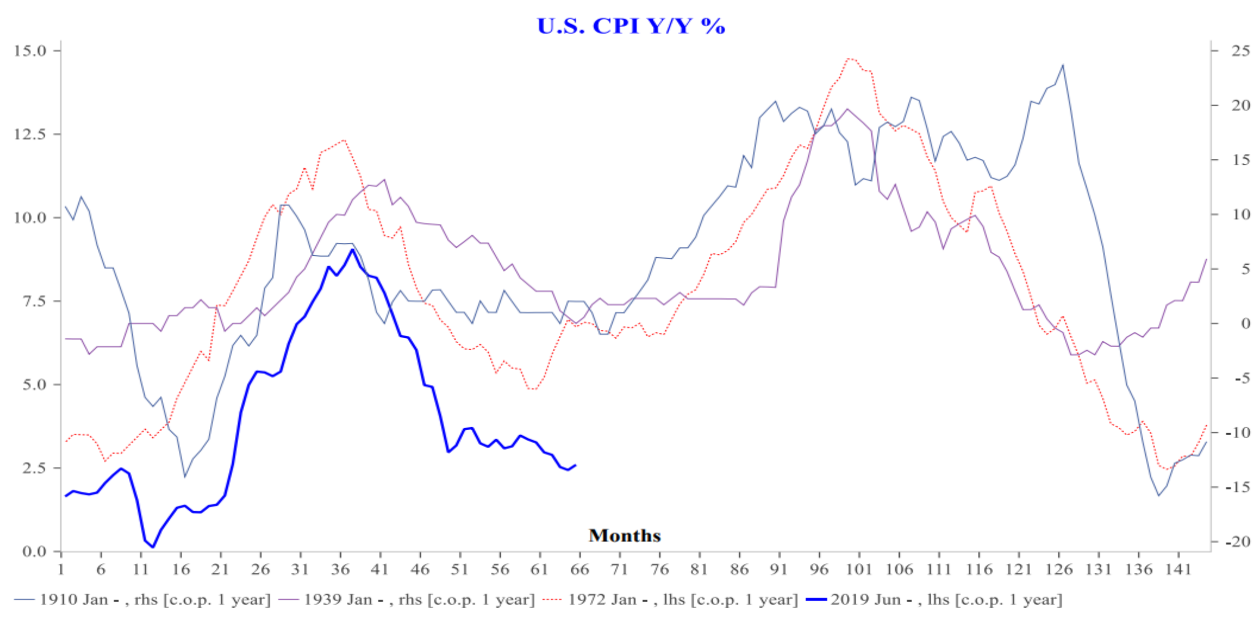
PCE inflation shows similar monthly trends. The chart on the right provides a more detailed breakdown of its components and shows that the increases across services has been fairly broad. This likely reflects continued wage pressures across service industries amidst strong consumer demand. The large increase in financial services inflation is partly reflecting strong financial markets and elevated asset prices, where fees taken are commonly a percentage of assets. The stronger insurance premium growth has begun to fade. Gasoline prices have been steadily falling toward $3 and should provide widespread relief across industries. Recent rent surveys have also shown waning pressures on new leases.

US PCE Inflation MoM%

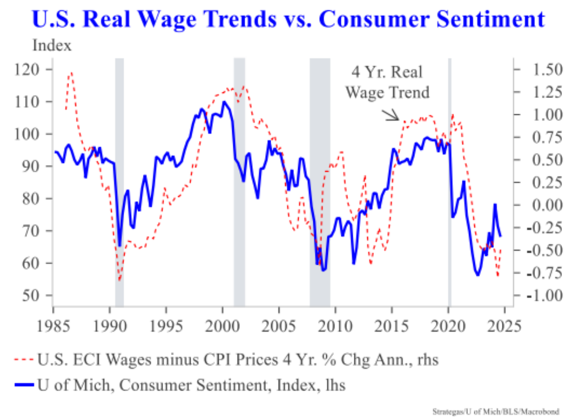
	weight	10/31/2024	9/30/2024	8/31/2024
Headline	100	0.238	0.180	0.117
Core	88.91	0.273	0.261	0.158
Core Goods	21.76	0.00	0.11	-0.17
Motor vehicles	3.65	0.86	0.27	-0.21
Home furnishings	2.44	-0.02	0.48	0.11
Recreational goods	3.34	-0.46	-0.28	-0.23
Other durables	1.46	-0.62	1.67	-0.91
Apparel	2.59	-1.39	0.70	0.50
Other nondurables	8.27	0.37	-0.37	-0.31
Core Services	67.15	0.36	0.31	0.27
Housing	17.95	0.44	0.37	0.33
Health care	16.84	0.09	0.33	0.13
Transportation	3.35	0.75	1.11	0.34
Recreation	3.94	0.62	0.19	-0.05
Food svcs	7.24	0.34	0.00	0.43
Financial Svc	7.92	0.70	0.12	0.42
Other Svc	8.34	0.33	0.39	0.00
Super-Core	49.20	0.36	0.31	0.21

Source: Wolfe Research, Haver Analytics, as of Oct 31, 2024

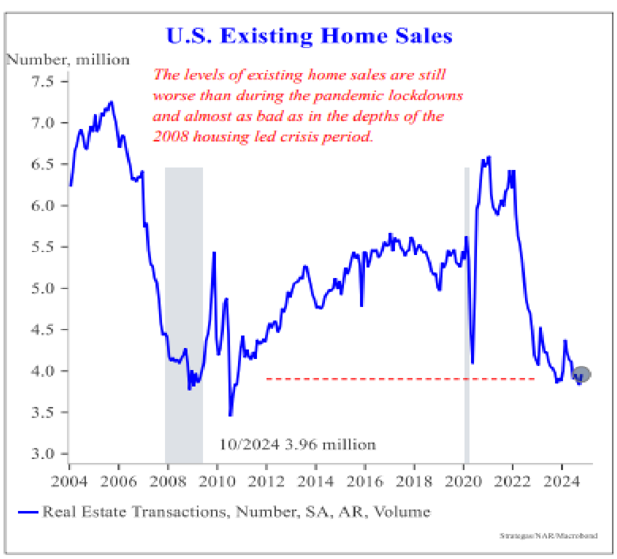
We spend a lot of time discussing inflation because of its widespread impact across the economy. Even though it has improved, it still deserves attention and should be cautiously monitored given its ability to restrict growth, limit investment, and erode capital and savings. While progress has been made and the recent upticks are not enough to suggest inflationary pressures are reaccelerating, it is important to be reminded that prior inflationary cycles have come in waves.

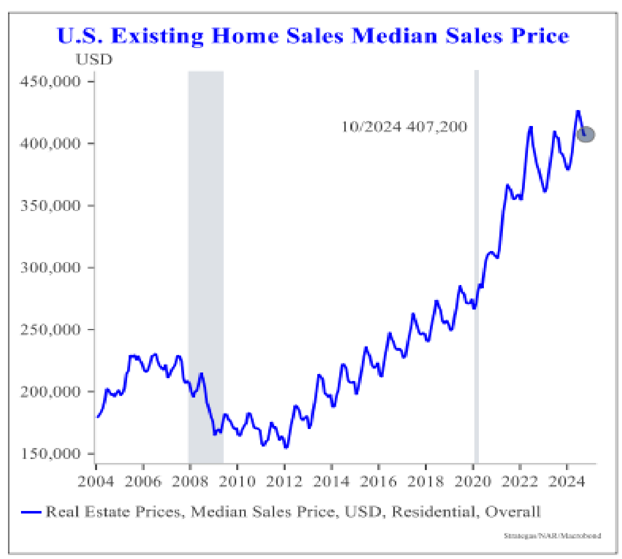


Ed Hyman with Evercore ISI recently pointed out that despite having slowed significantly over the past couple of years, the level of prices is still much higher with headline CPI up 22% since before the pandemic. He suggests many economists are out of touch with the reality of the average consumer when touting that inflationary pressures have subsided. Consumers are still very much feeling this and have felt a permanent erosion of real wealth and income. Despite higher financial markets and improving nominal wages, savings goals and retirement hopes have been slipping further out of reach as real wages and purchasing power have diminished. This explains the weak consumer sentiment and probably impacted the recent election, where many voters expressed economic concerns.



Housing activity remains depressed. Mortgage rates have come off their highs from a year ago but have ticked back up recently with the 30-year at 6.8%. Mortgage purchase applications have seen a slight increase, but it is hard to see what spurs more activity. Mortgage rates have been elevated for a couple of years now and prices have remained high, so some homebuyers who have been waiting to buy may be resigning to the fact that they will have to pay more for less house. Existing homeowners with low mortgage rates are reluctant to move, but as families grow, the need for additional space may eventually force them into action. The charts below speak for themselves, but existing home sales are extremely low. The increase in home prices is significant and limited new supply is keeping prices elevated. When combined with higher mortgage rates, it has left the housing market relatively frozen and continues to dampen housing-related spending.





With the topics generating a significant amount of attention in the press and among financial professionals, we should recognize that the U.S. economy is exposed to increased risk associated with shifting trade and immigration policies. These policies and the impact they may have on economic activity are unclear at this time. The logical conclusion is any policy shifts will be implemented with the intention to maximize U.S. economic strength and security, which are interrelated. The unintended and unforeseen impacts carry some risk from the simple fact that this is a shift in the path of previous policy. At this time, these policies have not been fully defined or implemented, so it seems premature to speculate on their ultimate impact and how they may interrelate with the various moving pieces within our economy. To view these policies and their economic effects in isolation seems illogical and likely to result in an inaccurate assessment of risk. Tariffs can lead to higher prices and more restrictive trade between countries. Historically over the past few decades, the U.S. economy has benefitted from open free trade relationships that have lowered the cost of goods for citizens. This has come with the loss of jobs in some sectors of the economy and less control over supply chains. Immigration has taken advantage of cheaper labor and supplemented labor supply while stimulating economic growth but has also carried economic costs unrelated to questions and views on border security. In isolation, more restrictive immigration policies and the deportation of large numbers of illegal immigrants could carry inflationary risks and depress growth in the near-term. For now, it seems prudent to be aware of these risks, but patient to see how these potential policy shifts progress.

The Federal Reserve began lowering the federal funds rate in September with a 50bp cut, followed by another 25bp cut in November. The rate is still at restrictive levels, leaving room for the Federal Reserve to continue lowering short term rates further if they feel inflation is under control. Easing the currently restrictive rate should help stimulate activity. Expectations have been for them to move back towards a neutral rate fairly quickly with inflationary pressures diminishing, however these cuts may proceed at a slower pace. Federal Reserve Chair Jerome Powell’s most recent assessment was that “The U.S. economy is in very good shape and there’s no reason for that not to continue . . . the downside risks appear to be less in the labor market, growth is definitely stronger than we thought, and inflation has come in a little higher. So, the good news is that we can afford to be a little more cautious as we try to find neutral.”

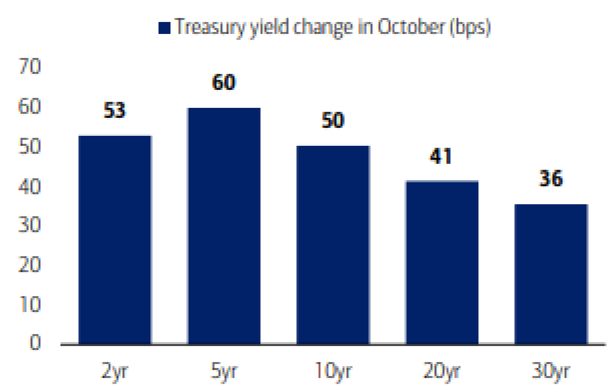
While we are comfortable that underlying economic conditions can support continued growth, we recognize that weaker employment and job losses would trigger a reduction in spending that would have ripple effects. Upper income households can continue spending, but the broader consumer base does not have as much capacity to continue spending at current levels. This will likely result in lower consumption that needs to be offset with increased business investment. Higher and more volatile interest rates have been working against this, but lower interest rates and policy clarity should encourage investment. Investments in artificial intelligence and related technologies is stimulative, but significant productivity gains are likely to be realized further out and these investments may prove more inflationary in the short run. Outside the U.S., it should be noted that geopolitical risk is still high with regional conflicts ongoing. Foreign economies are much weaker than the U.S and instability within foreign governments has been rising.

RSA PORTFOLIO STRATEGY
Fixed Income Strategy

By Lance Lachney

As the fund headed into the final quarter of its fiscal year, volatility began to rise as softer than expected data and a monthly decline in inflation led to a dramatic bull steepening in the yield curve. Chairman Powell's dovish posturing at the July FOMC press conference enhanced the market's expectations of a rate cut at the next meeting in September. Rate expectations plummeted shortly thereafter due to the sizable miss in payroll employment released in early August. Market participants began to price in approximately five interest rate cuts by the end of the calendar year. Corporate bonds fared well during this time as the resilience of the consumer kept the economy moving forward. Yield curve normalization resumed by early September after the spread between 2yr and 10yr treasury securities remained inverted for two years. Short-term treasury yields fell approximately 125bps since the beginning of July, and the number of expected policy moves had risen to ten by the middle of 2025. Policymakers delivered an outsized 50bp rate cut at their September meeting in an effort to move out of restrictive territory while inflation had stabilized. The fiscal year ended with a five-month rally in bonds and provided the fund with an approximate 11.5% total return.

Exhibit 4: Treasury yields sold off in October
Treasury curve bear-flattened in October, with 5 and 10yr yields up 60 and 50bps, respectively.

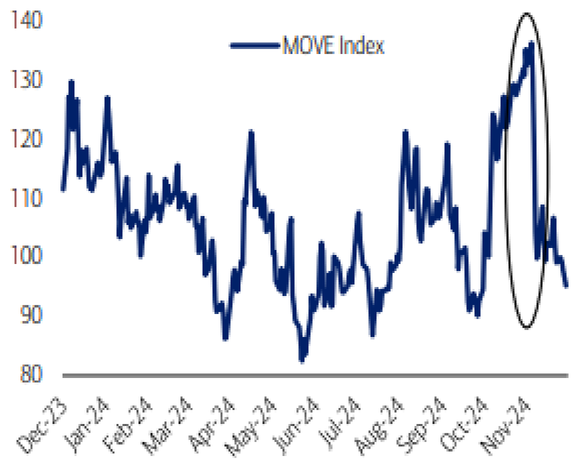


Source: Bloomberg

BofA GLOBAL RESEARCH

Continued strength in the economy halted the descent in yield levels as they bottomed out in mid-September around 3.55-3.60%. With the soft-landing narrative intact, interest rates moved higher at the beginning of the new fiscal year. A strong payrolls print of 254,000 and upward revisions to previous releases in early October pushed rates precipitously higher. Despite steady monthly increases in inflation, core prices accelerated to 3.3% on a yearly basis. Interest rates marched upwards throughout the month as retail sales and manufacturing data continued to surprise to the upside. Investment grade and high yield spreads were able to tighten during this time reaching pre-GFC levels. Of note, global public debt is quickly approaching $100 trillion and domestic interest payments have increased 33% in the latest fiscal year. The Bloomberg Aggregate lost approximately 2.50% in October, with mortgages underperforming due to its duration and negative convex profile.

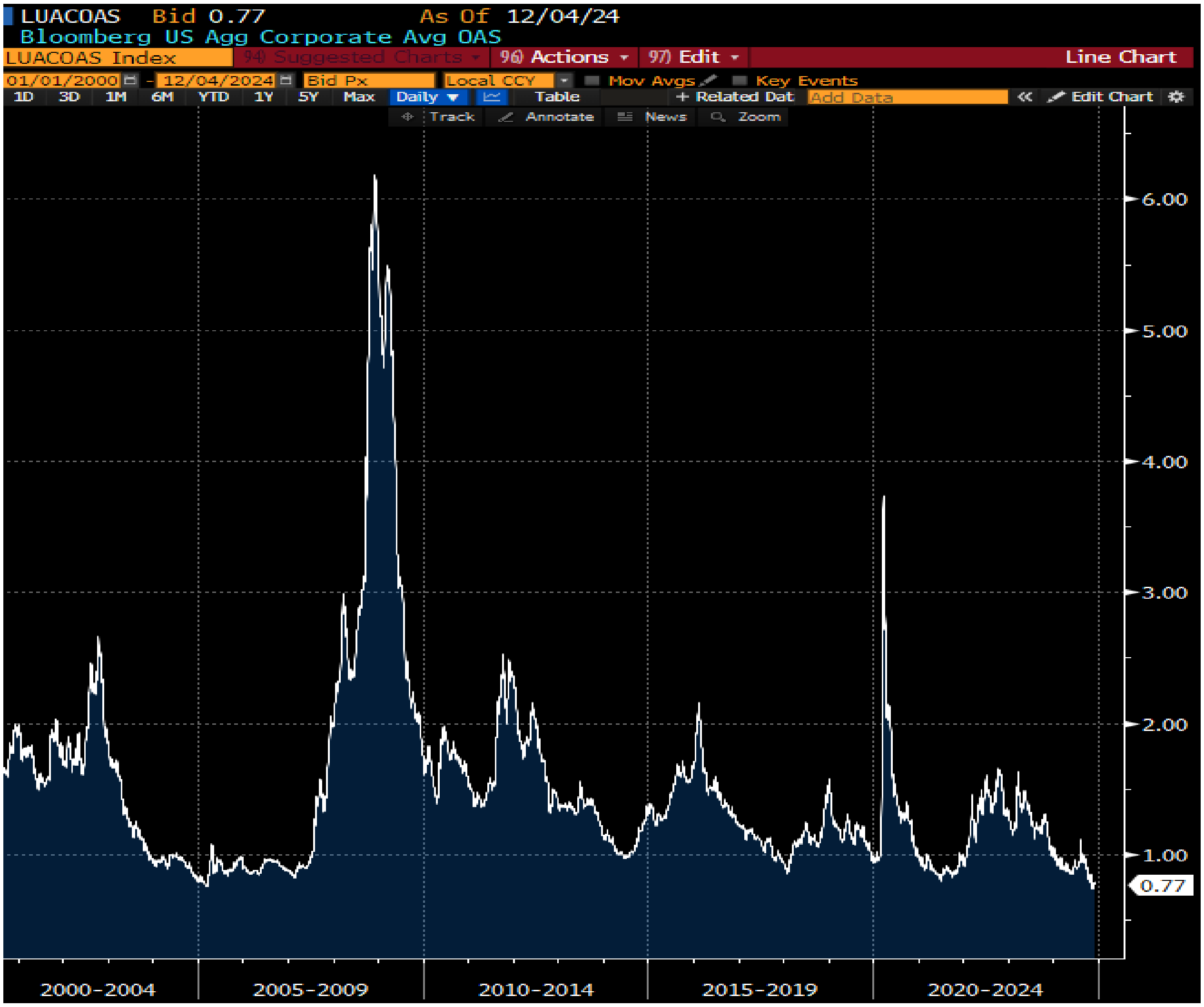
Exhibit 2: Rates vol dropped significantly after the US elections
MOVE index declined to September lows by the end of November.



Source: Bloomberg

BofA GLOBAL RESEARCH

Bond volatility rose to its highest level in over a year leading up to the U.S. elections. Treasury yields continued to climb following the Republican sweep as fiscal deficit concerns came into focus. Real yields and inflation expectations rose meaningfully higher due to some of the policies proposed by the former president during the campaign. Ten-year treasury yields peaked close to 4.50% intraday, a 90bp move in a short amount of time. The FOMC lowered interest rates for a second time a couple of days later, emphasizing that employment and inflation goals were "roughly in balance". Chairman Powell also reiterated later in the month that current economic conditions have allowed the committee to be patient regarding policy decisions. Meanwhile, upward revisions to retail sales and the continued monthly moves higher in core inflation have made the decision in December a coin-flip. The treasury market has rallied a fair amount over the last couple of weeks. Some of this is due to the selection of a few market-friendly nominees for cabinet positions in the new administration. There have been some geopolitical issues in the Middle East, South Korea, and France. Nothing alarming, but the data recently has also weakened a bit at the margin.



Source: Bloomberg

Trading activity during this time has been somewhat limited. There have been no additions to the corporate sector as we do not envision a substantial move for spreads to run at this point in the cycle. From a technical standpoint, I suppose spreads could grind a little tighter due to lack of issuance during the holiday season. The fund is comfortable in its current overweight tilt towards corporate debt. However, it is difficult to get excited when the spread portion of overall corporate yield levels is hovering around 15%. Treasury purchases have been made within the belly of the curve in order to increase the fund's weighting and duration at the margin. The fund has recently purchased a few mortgages to increase exposure at relatively attractive levels, as net issuance in the sector sits at nine-year lows. The fund has also purchased its first callable agency in some time, mainly as a cash surrogate receiving 5.80% for one year.

Going forward, it appears the Fed will lower short term interest rates by 25bps at its December 18th meeting, absent a surprise in the inflation data due next week. Today's payroll report was somewhat of a mixed bag. The number reported came in above expectations, however the household survey conveyed weakness with the unemployment rate creeping higher and the participation rate falling. As a result, the yield curve is bull steepening with shorter term rates falling a little faster than the long end of the curve. Market expectations are that policymakers will pause come January with a new administration taking the reins and lower rates two additional times during the first half of 2025. Any forecasting past that point is frivolous with the uncertainty regarding policy proposals, inflation, labor, and their effects on the economic landscape**.**

Domestic Equity Strategy

By Hunter Bronson

As we approach the end of the calendar year, the domestic equity market has continued to display both impressive resilience and momentum. The S&P 500 was up just over 36% for our FY2024. With just weeks left in calendar 2024, the S&P 500 is on track to jump more than 29%, marking the second consecutive year of gains of that magnitude, a back-to-back advance that has been seen only three times over the last century.

This has been driven in large part by investors' growing optimism for a soft landing for the U.S. economy. Despite the strong momentum, as we review recent trends, we cannot ignore the increasingly stretched valuations and persistent interest rate risks that could alter the current trajectory and possibly lead to more turbulence.

The roaring market rally since the U.S. presidential election has driven up the price of risk assets across the board - from shares of tech and manufacturing giants to cryptocurrencies. Investors have stampeded into funds tracking U.S. stocks and piled into trades that would profit if the momentum continues that recently sent the S&P 500 above 6,000 for the first time.

Figure 1: The S&P 500 powered through early-year hard landing fears and has consistently traded above its 50 & 100 day moving averages for most of the year.

This report will cover the main drivers behind recent market performance, address key valuation concerns, and lay out our outlook for 2025. Additionally, we will discuss the broader macroeconomic factors and specific sector-level dynamics that are shaping market sentiment.

Market Performance and Valuation

As mentioned, the S&P 500 has seen a strong run throughout 2024, largely on the back of evolving expectations for a soft landing and potential for further easing in Federal Reserve policy. While we didn't get the number of 2024 Fed rate cuts baked into the original consensus forecast, the inflation path remained benign enough to bolster confidence throughout the year. However, the rally appears to have overshot fundamental valuations, as index-level multiples are within shouting distance of all-time highs and sentiment is frothy. Financial pundits like to blame extreme levels of optimism on YOLO-believing, meme-stock trading individual investors, but as you can see in Figure 2, equity positioning is at extreme levels amongst the professional crowd, as well.

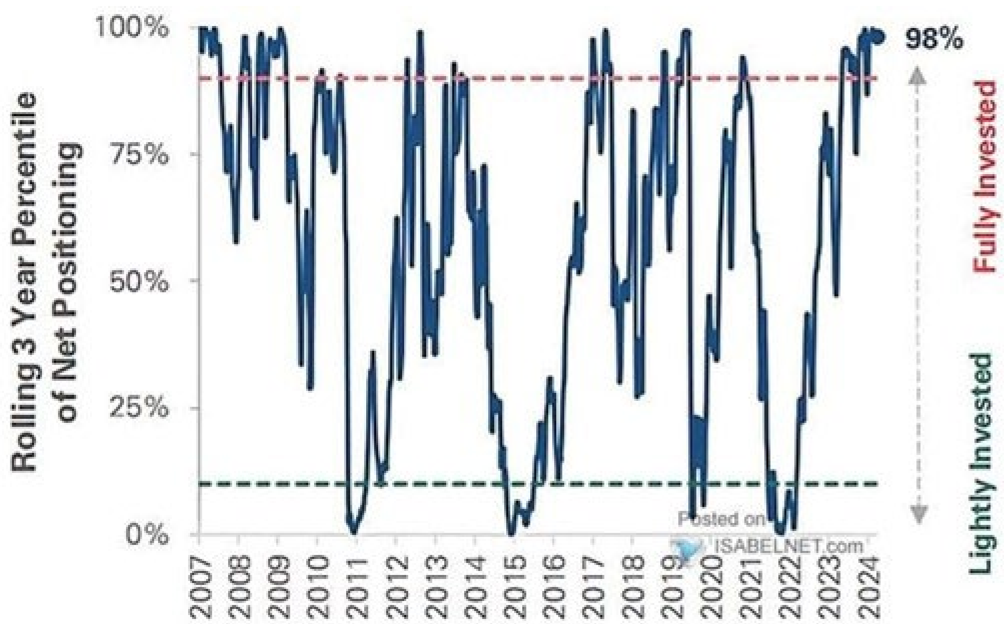
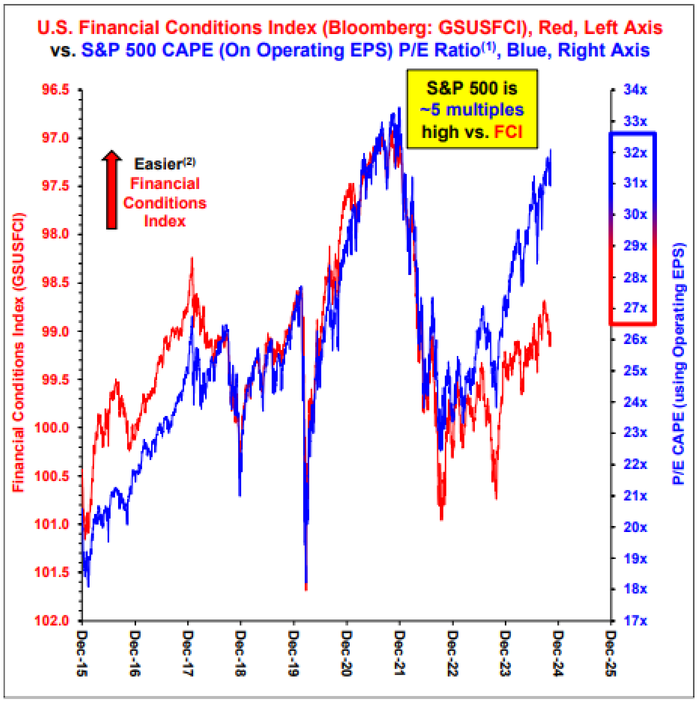


Figure 2: Professional asset managers have swung from a net neutral position to a nearly maximum long position over the last 24 months. Source: MarketDesk Investment Committee Handbook, CFTC

The challenge for the S&P 500 moving forward is not earnings per se. As you can see on the right in Figure 3, smoothed S&P 500 operating earnings have historically grown at just under a 4% CAGR and are currently dead-on trend. Statistically speaking, we shouldn't expect anything to alter this level in the near term. On the whole, S&P 500 companies are neither over-, nor under-earning at the moment.



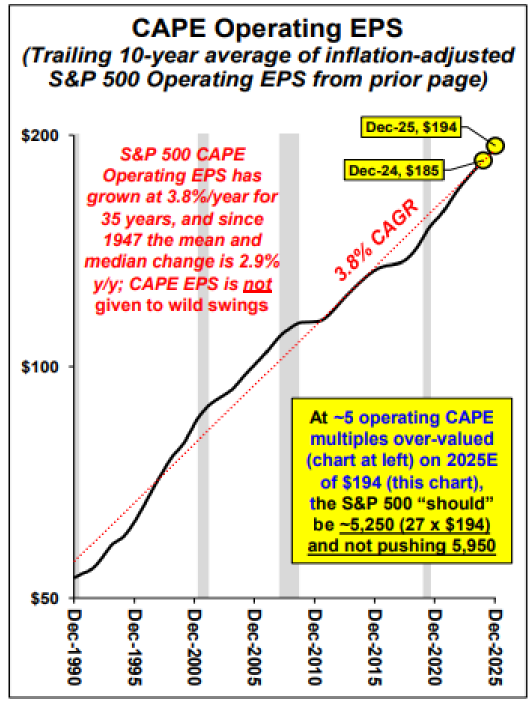


Figure 3: S&P 500 Operating EPS (right), remains dead-on trend, neither under-, nor over-earning. We should expect this to continue. However, valuations (left) are challenging. Source: Stifel

However, elevated valuations are creating pockets of vulnerability. The 12-month forward PE is well above its previous 20-year high and mean. While the higher valuations of very large mega-caps explain some of this, the median stock is also still trading close to record valuations dating back nearly 50 years.

	Aggregate index		Median stock	
Metrics	**Current**	**Historical %ile**	**Current**	**Historical %ile**
EV / sales	3.4	100 %	3.5	97 %
Cash flow yield (CFO)*	5.1 %	100 %	5.8 %	95 %
Price / book*	5.3	99 %	3.7	98 %
EV / EBITDA*	16.5	97 %	13.8	94 %
Forward P/E	22.3	95 %	19.2	95 %
Cyclically adjusted P/E (CAPE)	34.3	96 %	NA	NA
Free cash flow yield*	2.9 %	77 %	3.6 %	63 %
Median absolute metric		**97 %**		**95 %**
Yield gap vs. real 10-year UST	240 bp	91 %	310 bp	90 %
Yield gap vs. 10-year UST	6 bp	89 %	76 bp	71 %
Yield gap vs. IG**	-76 bp	88 %	-5 bp	84 %
Median relative metric		**89 %**		**84 %**

**data since 1987*

***data since 1999*

Figure 4: Most standard valuation measures are very stretched, even for the median stock. Source: Goldman Sachs

The rise in valuations across the board has, to a large degree, been driven by interest rate cuts and the anticipation of future rate cuts. However, longer-term yields have been stickier, leading to a steeper yield curve. This implies growing confidence in the long-term outlook for economic growth. However, with valuations remaining high, it also implies that equity risk premiums have fallen to historic lows. Essentially, investors are demanding very little excess return for added risk.

We could reasonably continue to see S&P 500 gains in the mid-single to low-double digit percent range if the market continues to price in these high valuation levels, but a flatter, choppier market is more likely should we see a pullback in investor sentiment and multiple compression.

Figure 5: A longer-view look at valuations approaching 50-year extreme levels only seen in the early 90s and aughts. Source: Bloomberg

Another cautionary aspect of the current outlook is the narrow leadership within the market. While growth stocks, particularly in the technology sector, have led the way throughout much of the year, there are indications that growth's outperformance over value is near a peak. Populist and reflationary policy and potential geopolitical shocks could all favor a reversion toward value-oriented stocks in the medium term. While this development would certainly be welcomed by active managers, overall index-level returns could be hampered by faltering leadership. Calling reversals in powerful trends is always uncomfortable and often foolish, but the valuation and outperformance levels of growth over value in the last 15 years (Figure 6) are striking.

On a positive note, the overall market has so far taken the early change in leadership in stride. Since the July 10th Magnificent Seven peak, only Tesla is up, and the broader market has continued to rally. Broad-based rallies tend to be healthier and more resilient, so this is a good sign for 2025.

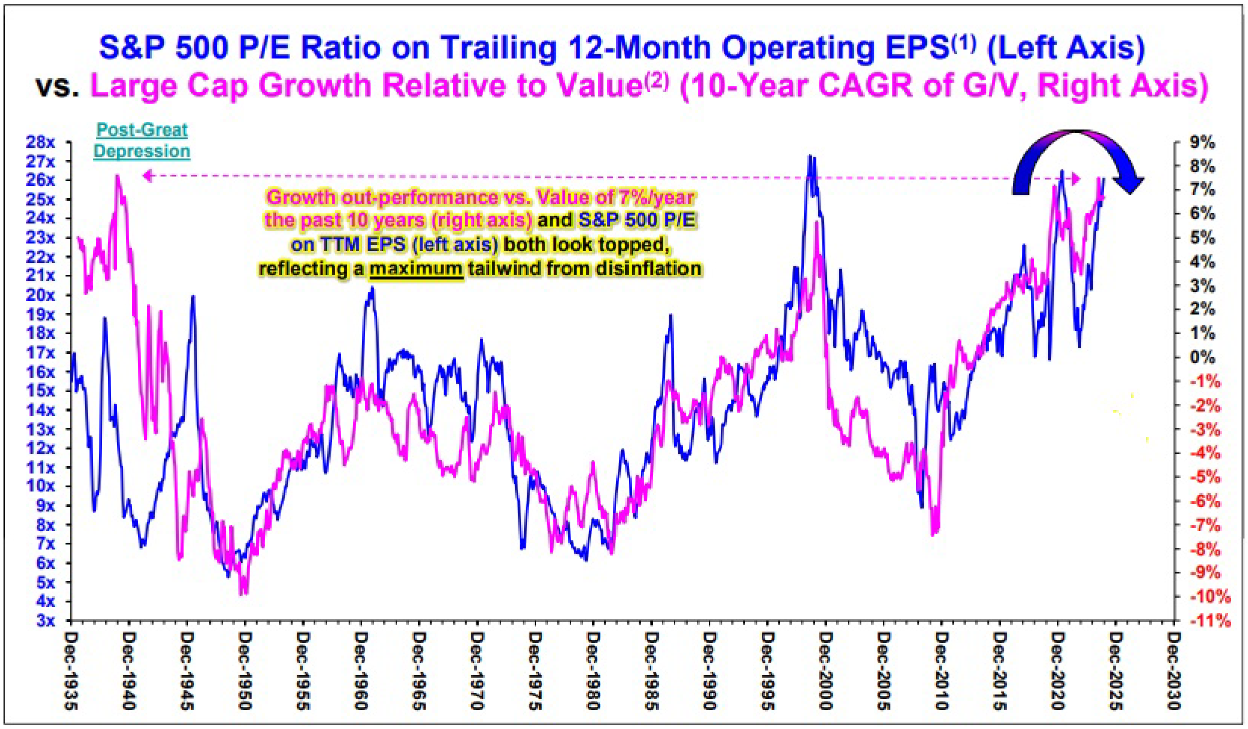


Figure 6: Growth has continued to trounce value (pink), but the level of outperformance has reached historic peak levels. Source: Stifel

Looking ahead to 2025, the interplay between growth and value stocks, as well as between defensive and cyclical sectors, will be critical. Historical parallels suggest that the current market setup resembles past periods where growth's dominance eventually gave way to value as inflation and fiscal policy shifted.

Macroeconomic Conditions

On the macroeconomic front, third-quarter earnings were robust, with EPS growth reaching nearly 9% YoY - slightly ahead of expectations. Excluding the energy sector, earnings growth was even more impressive at 11.5% YoY. Revenue growth was similarly solid, demonstrating broad contributions across sectors.

Early reads on Q4 look equally good with Black Friday sales and Cyber Monday sales up 10% and 6%, respectively. Employment remains robust, and consumers continue to drive the economy by spending their higher disposable incomes and enjoying record net worth (Figure 7). However, it remains to be seen how much total Q4 activity will have been a pull-forward ahead of expected tariff announcements from the new administration. We saw a similar flurry of activity in 2018 ahead of Chinese tariffs that caused some distortion in the data.

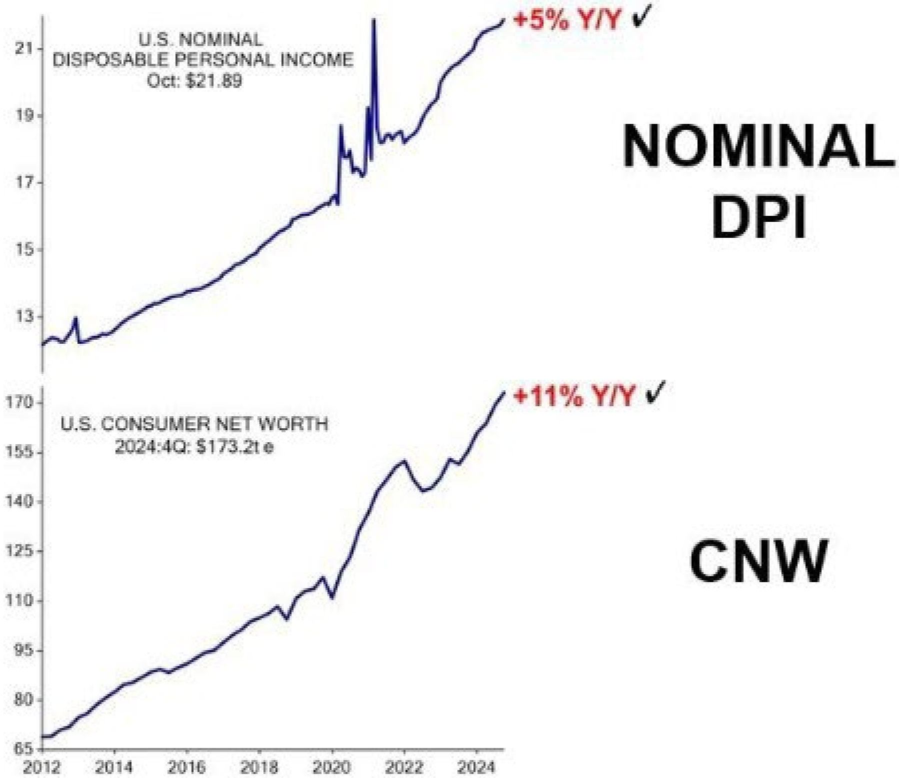


Figure 7: Bolstered by gainful employment and growing incomes, consumers continue to drive earnings higher. Source: Evercore ISI

We believe the most significant ongoing macroeconomic risk continues to be inflation. Although the consensus view is that inflation will continue to moderate, with valuations near all-time highs, we believe that outcome to be fully priced into stocks. There are non-trivial risks that a second wave could emerge, driven by a myriad of factors such as coordinated global monetary easing, outsized GDP growth, potential mass deportations, rising wages, and geopolitical tensions. Interesting research from both Stifel and Strategas indicate that second and third inflation waves are, historically speaking, the norm rather than the exception.

The Federal Reserve's response to these inflation dynamics will be crucial. If inflation remains sticky around 3-4%, the Fed may feel compelled to keep rates higher for longer, which would likely weigh on equity valuations. Past multi-period inflationary cycles bear this out, as equity markets typically revert to their pre-inflationary levels.

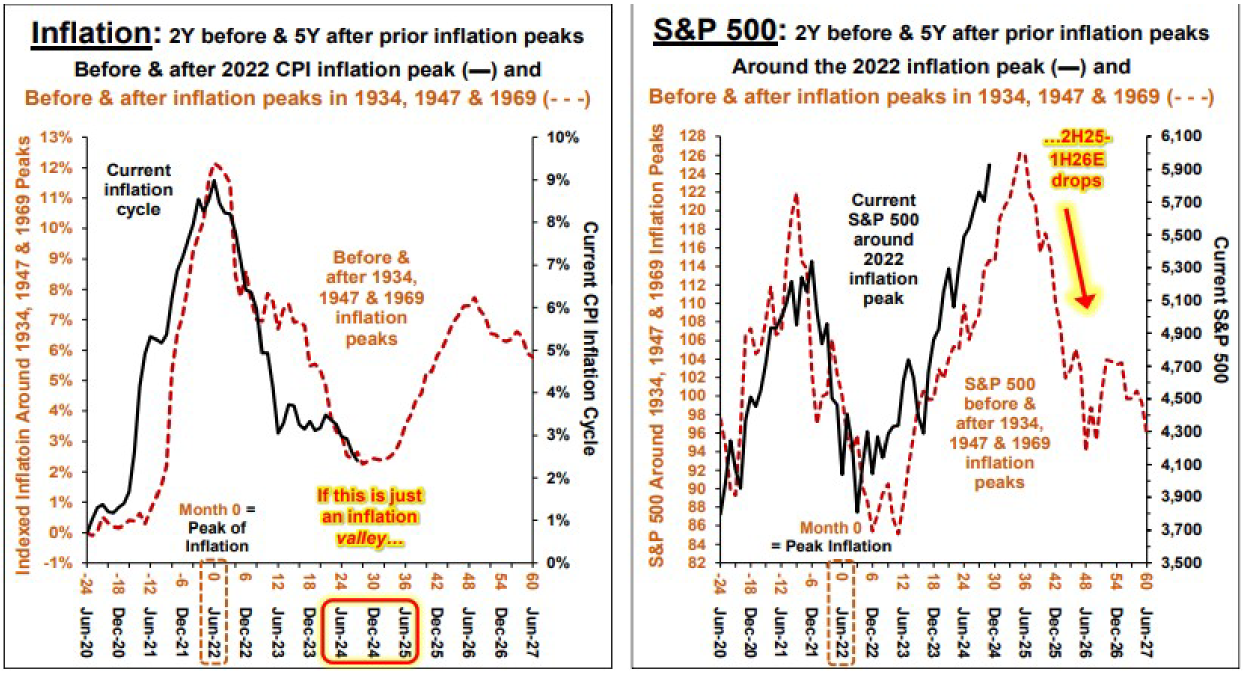


Figure 8: Historically, reflationary cycles have led to equity market pullbacks. Source: Stifel

Conversely, if inflation has been tamed, there could be room for policy easing, which would support valuations and potentially drive further market gains – at least in line with earnings growth.

While we consider inflation to be the most dangerous risk to equity markets, we would not consider reflation to be our base case for 2025. Following six months of steady progress beginning in March, disinflation has stalled in the most recent months, causing a bit of a resurgence in concern about a broader pick up in prices. Additionally, some investors fear that some of President-elect Trump's more protectionist and populist policies could keep inflation elevated.

However, goods inflation still seems benign, shelter should continue to slow on a lagged basis due to measurement issues, and the labor market is in a much more balanced position relative to the last 5 years. Furthermore, we continue to believe that, as in 2016, many of the Administration's more radical proposals will soften over time. However, we are certainly going into the new year with our eyes open.

2025 And Beyond

To sum up 2024 before it has officially ended, it looks as though earnings will have contributed roughly 10% to overall S&P 500 returns. Assuming the index holds its position over the closing few weeks, valuation expansion and dividends will have contributed roughly an additional 19%.

From an earnings perspective, 2024 was a perfectly average year, especially in the post-GFC age of Mega-tech dominance and the stickier, higher margins that come with it

(Figure 9). Early consensus forecasts for 2025 anticipate an acceleration in earnings growth to 12-13%. We are a bit more sanguine, as early forecasts tend to overshoot, but 9-10% is a fair estimate.

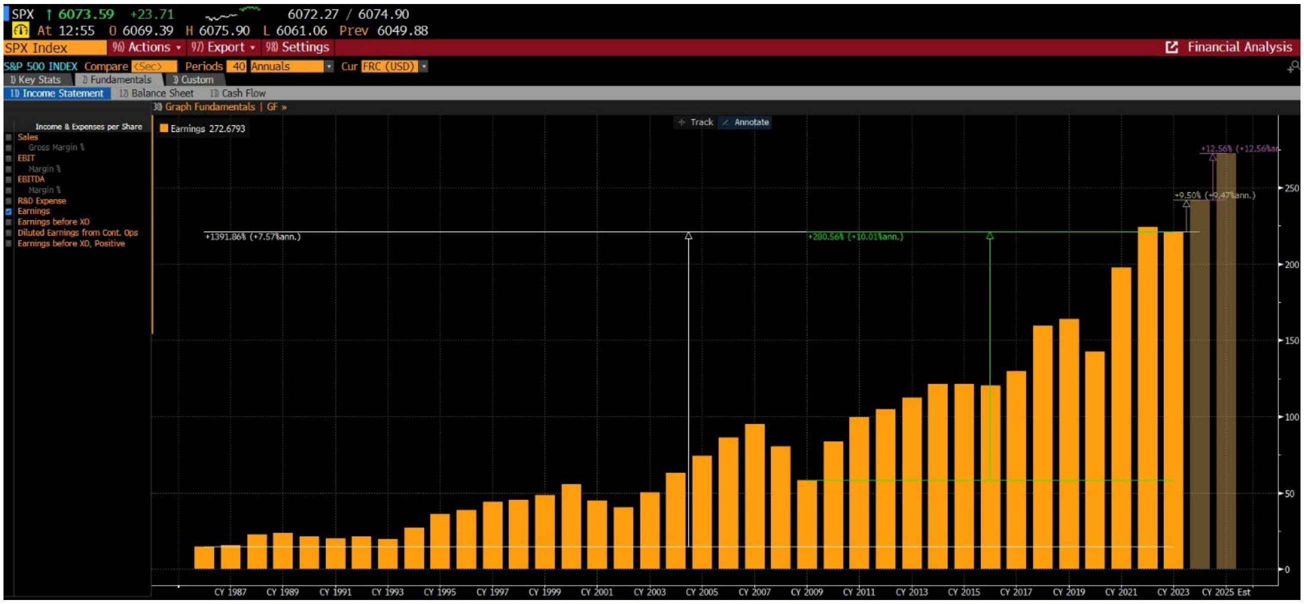


Figure 9: The current earnings trajectory is right on trend. We expect that to continue. Source: Bloomberg

On the other hand, we think it's a tough bet that valuations will continue to expand from here. That's not to say it isn't possible, as expensive stocks have become more expensive in the past. Valuation has always been a terrible timing tool (Figure 10), so this is more of a longer-term concern. However, we think it is safer to assume that multiples will either tread water or start to come down, especially over a 10-year time horizon.

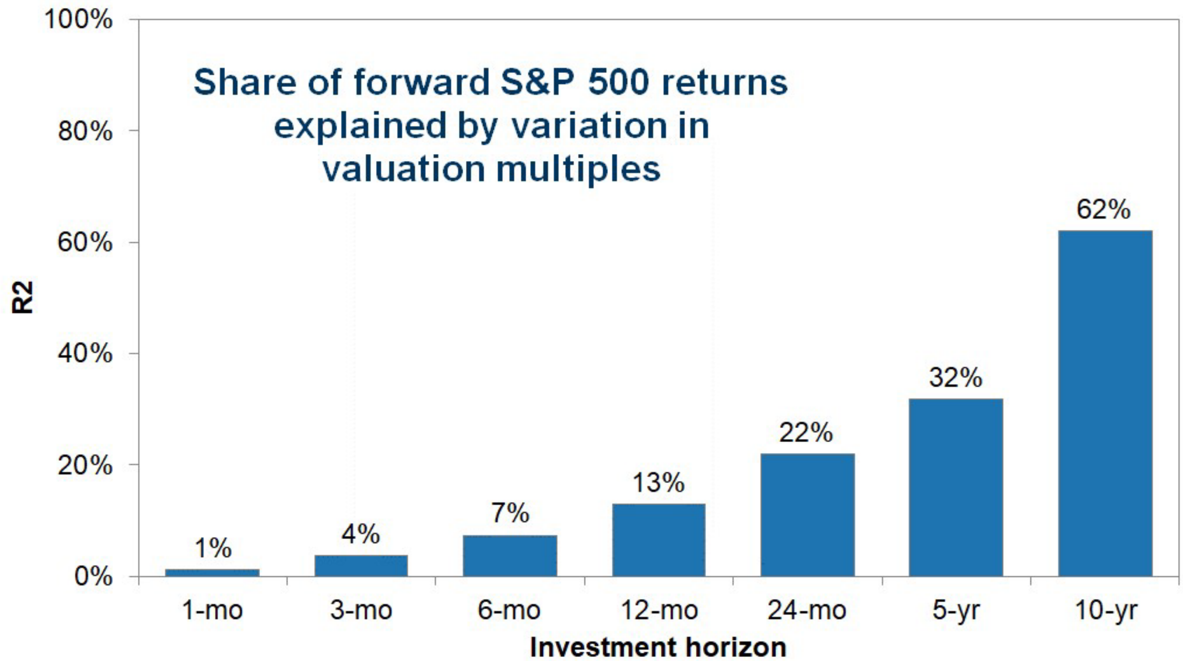


Figure 10: Valuations explain much more of total return in the long run as compared to the short run. Source: Peter Oppenheimer

In short, we believe 2025 should be a more "normal" environment for stocks in which earnings growth explains a larger portion of the ultimate total return. Further easing of monetary policy and geopolitical tensions could juice returns a bit, but we doubt we see the rocket fuel that expanding multiples have provided the past couple of years.

From a tactical standpoint, as a staff, we have been disciplined about trimming our overall domestic equity exposure as stocks have run up in 2023 and 2024. We think this is prudent, as we can't help but think that at least some portion of those returns have been "super-normal," and we must operate within the sensible boundaries set forth in our Investment Policy Statement. As an office mostly full of CFA Charterholders, we also tend to have a bit of a Value tilt. Should the market continue to broaden out and become more earnings driven, we should have more opportunity to continue to add active value through stock selection in our active funds. We are cautiously optimistic for 2025 while keeping a close eye on inflation and rates and any potential disruptions from major policy shifts.

International Equity Strategy

By Steve Lambdin

The global equity markets finished our fiscal year in wonderful fashion, with robust third quarter returns as many equity markets finished near record highs. U.S., international developed, and emerging market equities all finished in the green. Global central banks cut interest rates as inflation continued to fall in most regions around the globe. Nearly half of global central banks are now in easing mode. In a major surprise, the People's Bank of China (PBOC) and the Chinese government announced a host of monetary and fiscal stimulus measures in the period targeting liquidity and the ailing property markets across the region. Collectively, these measures are expected to represent the largest stimulus actions since the great recession of 2008. These announcements led to a late September surge in the equity markets in China and Hong Kong. This was welcomed by investors in this region as Chinese equities have been underperforming over the last several years as many investors have neglected owning this market. Global Purchasing Managers Indices (PMI's) have remained around the critical 50 level over the last couple of months, with the service PMI's remaining firm and the manufacturing PMI's being weaker. In addition, global employment remains strong in many of the major economic regions around the world. For now, it appears the "soft landing" scenario floating around in the marketplace will be the most likely outcome.

The news flow out of Japan over the last several months has been very eventful. After a surprise interest rate hike by The Bank of Japan (BOJ) in late July, the NIKKEI Index fell -20% over the next week as investors had to sell Japanese equities to cover losses on the carry trade. The Japanese carry trade is when an investor borrows money in a currency with low interest rates (Japan) and invests this money in a currency with high interest rates (U.S.). This trade requires a stable currency and low volatility to work. Unfortunately, a lot of leverage is usually put on these trades. So, when surprise interest rate announcements happen, these trades unwind in a hurry and create a lot of pandemonium in the equity markets. After this surprise move, the BOJ has kept its key benchmark rate stable through the end of November and this has allowed a good recovery in its equity markets.

In its October 2024 update, the International Monetary Fund (IMF) maintained its projection for 2024 global growth at +3.2%. However, under the surface we saw a slight upgrade to U.S. growth and slight decreases to Eurozone and Emerging Markets growth. The IMF report cited disruptions to shipping of commodities from civil unrest and conflicts as the two main culprits. Over the next few months, the IMF sees the risks to the global outlook tilted to the downside. On a positive note, and as mentioned briefly above, the Chinese equity markets rallied significantly in late September after the stimulus announcements, finishing +23.6% in the third quarter and at a three-year high.

Geopolitical tensions have continued to rise over the last several months. The war in the Middle East has grown significantly as Israel and Iran have traded missile strikes recently. Thus far these strikes have not led to any major disruptions in global trade or economic pain, but things can change in a flash of a moment. The war in Ukraine has expanded even further since our last update. We are now seeing North Korean military troops in Ukraine to assist in the Russian invasion. As a result, Ukraine received U.S. approval to use more advanced U.S. missiles to penetrate targets deeper inside of Russia. In addition, Ukraine continued to receive new military aid packages from several NATO nations to thwart the Russian assault. We view these moves as fresh significant developments in this conflict. We still find it amazing with all the global conflicts happening now that many equity markets are at or very near all-time highs. Clearly, investors do not seem to be overly worried. We will see if this continues to be the case going forward.

	September 2024		3Q 2024		YTD 2024	
Equity index returns (%)	U.S. dollar	Local currency	U.S. dollar	Local currency	U.S. dollar	Local currency
S&P 500	2.1	2.1	5.9	5.9	22.1	22.1
MSCI ACWI	2.3	1.9	6.6	4.9	18.7	18.7
MSCI ACWI ex USA	2.7	1.6	8.1	3.2	14.2	14.2
MSCI World	1.8	1.5	6.4	4.7	18.9	18.7
MSCI Emerging Markets	6.7	5.6	8.7	6.6	16.9	18.3
MSCI EAFE	0.9	–0.4	7.3	0.8	13.0	12.0
MSCI Europe	0.4	–0.7	6.6	1.6	12.8	10.9
MSCI Pacific	2.0	0.2	8.5	–0.9	13.2	13.8

Source: RIMES; Capital Group

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +7.3% and +8.7% respectively during the third quarter of 2024 vs. +5.9% for the S&P 500 Index. Strong equity markets in Germany, Spain, Hong Kong, and Singapore propelled international developed stocks over U.S. stocks, while a strong Chinese equity market led the surge in emerging markets. The U.S. dollar fell against the yen and the euro, pushing the U.S. dollar index down by -4.8% in the period. This helped returns for unhedged U.S. investors in the MSCI EAFE Index and, to a lesser extent, investors in the emerging markets. For the third quarter, the Asian region was stronger than the European region, as several of the Asian equity markets were very strong in the period. Ten out of eleven sectors of the MSCI EAFE Index posted positive returns, with real estate, utilities, and financials leading the way in the quarter. The energy sector was the only sector not to record a positive return in the period. The Bloomberg Commodity Index was a mixed bag and was nearly flat in the quarter, even as WTI crude oil fell -16%.

With the U.S. election now over, the fourth quarter has been eventful thus far. The Trump sweeping victory has pushed the U.S. equity markets to a fresh record high. However, the exact opposite has transpired in the global markets outside of the U.S. Investors believe that Trump policies being circulated around the marketplace will put a damper on companies exporting to the U.S. Tariffs on goods shipped from China, Mexico, the Eurozone, and Canada are in the crosshairs. Overall, major economic reports continue to be a mixed bag with a negative tilt toward them, especially in Europe and parts of Asia.

Inflation has continued to fall in most parts of the world, keeping up the trends that have been in place for most of 2024. So far in the fourth quarter, the MSCI EAFE Index and the MSCI Emerging Markets Index are down -5.7% and -7.2% respectively, while the S&P 500 Index is up +5.1%. This is quite a divergence in performance and clearly show U.S. equities has been the place to be in the equity markets.

The following pages provide an update to what we see as relevant issues in the marketplace which could set the direction of equity markets over the next few months.

Issues/Points:

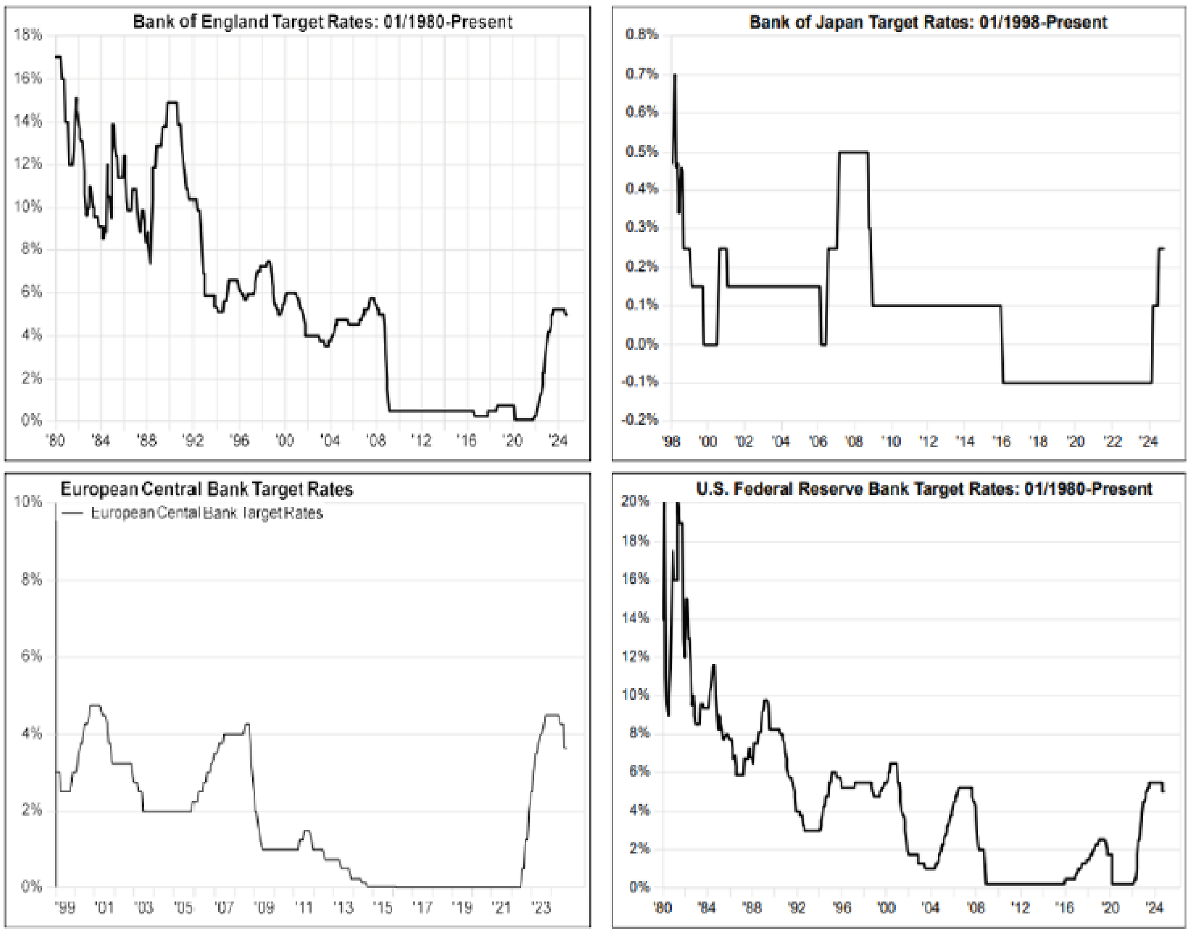
President-Elect Trump Policies – We believe the rhetoric surrounding what Trump might do regarding U.S. trade policy during the next four years is a giant wildcard. There have been dozens of "tweets" and statements made by Trump and his proposed cabinet members since his election victory. Most of these seem to be targeted at China, Mexico, Canada, and the Eurozone. How many of these that come to fruition is a giant wildcard now. Most are expecting higher tariffs, especially with Chinese goods. Trade relations with China could grow even more precarious over the next year. Automobiles being imported from Mexico and Canada could be targeted for significant tariffs. This would have major ramifications for the automobile industry if implemented. Most of these actions could be taken by executive order and not congressional action. Also, as trade agreements expire over the next few years, these could be re-negotiated at significantly different terms. With these points in mind, this could favor U.S. centric companies over companies outside of the U.S. and U.S. equities over global equities. The U.S. dollar could remain strong under this scenario.

Sample of Presidential-Candidate Economic Policy Proposals

Economic policy	Some change	Big change	Impact
Trade	60% tariff hikes on China	10% tariff hikes on all countries	Higher inflation Slower growth
Immigration	Reduce inflows	Mass deportation (11 million unauthorized)	Higher inflation Slower growth
Fiscal/ Regulatory	Lower corporate taxes Less regulation		Supportive of corporate earnings/stocks
	Higher corporate taxes Higher taxes on capital gains More regulation		Headwind for corporate earnings/stocks

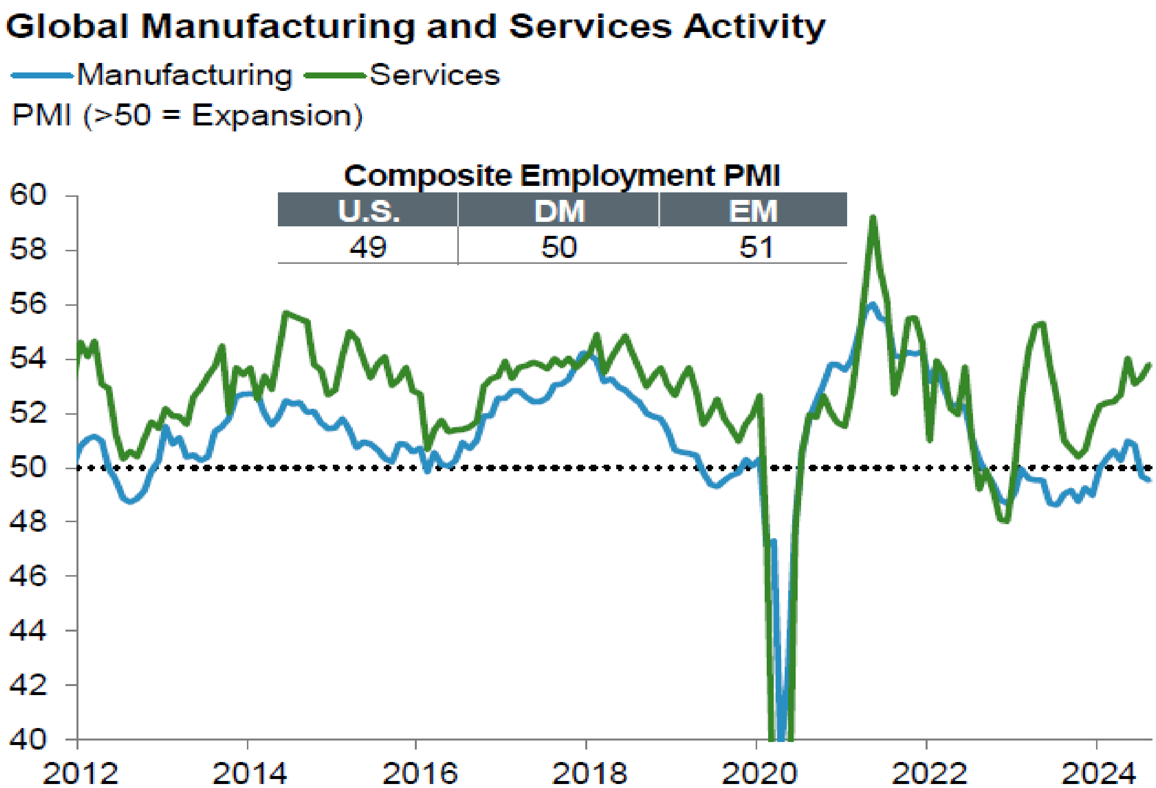
Source: Fidelity Investments

Global Central Banks – Most investors believe that global central bank policies will be a major determinant of the direction of equity markets over the next year. We still expect the European Central Bank (ECB), Bank of England (BOE), and the U.S. Federal Reserve (FED) will continue to lower benchmark interest rates as we move through 2025, while The Bank of Japan (BOJ) will probably have a flat to slight upward bias toward interest rates. However, it's hard to gauge to what degree these actions will transpire. The BOE could be slower than the ECB in the coming months. The FED could slow the pace of cuts if inflation becomes stickier than expected. Any changes in interest rate expectations could push markets significantly higher or lower. Interpretations of economic data points by the global central banks will be crucial to see how this plays out in 2025.



Source: Eagle Global Advisors, Factset

Direction of the Global Economy – We continue to maintain our view that the global economy is stable but has a slight downward bias. While the U.S. economy will most likely slow down a bit in 2025 from 2024, many economists see the Eurozone, the United Kingdom (U.K.), and Japanese economies picking up in 2025. China and India will still see their respective economies grow, but at a slower rate than in the recent past. Manufacturing data has been weak in many regions, but this has been offset by investments in artificial intelligence around the world. With these issues in mind, it's always a risk as expected growth leadership changes from one major region to others. This can make investors very nervous and equity markets volatile.



Source: Fidelity Investments, Markit, ISM, S&P Global, Macrobond

China – With China representing the second largest economy in the world, developments in this country can have major ramifications for global markets. Late in the third quarter, the Chinese equity markets got a huge shot in the arm as The PBOC unveiled a host of stimulus measures targeted to support a slumping real estate sector. These measures include a cut in the required reserve ratio for banks, reductions in down payments for mortgages, and actual cuts in mortgage rates for existing loans. In addition, we saw measures aimed to support the equity market as the PBOC set up swap facilities for financial firms to hedge their holdings of financial assets to obtain liquid assets. Also, a 300-billion-yuan program has been set up to give loans to major companies for share repurchases. These announcements pushed Chinese equities to the biggest five-day move in nearly five years. We interpret these aggressive actions by the Chinese leadership as an attempt to stimulate a deteriorating economic backdrop. China has been battling deflation over the last couple of years as Core CPI has hovered around zero level recently. Composite PMI readings have also been hugging the critical 50 level over most of 2024. In addition, recent consumer confidence surveys have been very weak. All of this puts the government's 5% GDP growth target in jeopardy. It's too early to tell if these stimulus measures will have their desired effect on the economy, especially as trade impacts from new tariffs could kick-in early next year.

Figure 39: Trade war could hit China's exports to the US again which is only 3% of GDP as of today

Source: Deutsche Bank, IMF

Geo-Political Risks – Global conflicts continue to escalate with each passing month. These conflicts have the potential to threaten global economic growth and abruptly change the direction of financial markets in a hurry. First, the war in Ukraine keeps escalating with each passing month. Recently, North Korean troops entered the fight as approximately 10,000 troops were sent to Russia. Also, Iran has recently increased shipments of drones to Russia to help its war effort. Countering this has been fresh military aid packages from the U.S. and a few other NATO allies. The U.S. has also given approval and sent more sophisticated missiles capable of hitting targets deeper inside of Russia for the first time. These actions indicate to us a significant intensification of this war. Other areas of contention are not improving either: Israel/Iran; Israel/Hamas; Houthi missiles targeting Red Sea shipping lanes; U.S./China/Taiwan; and the Korean peninsula. However, the amazing thing is equity markets have not been impacted much by these global hot zones, as many equity markets remain at or near all-time highs. This has been a surprise to us, but we realize things can change quickly.

Source: Fox News

Final Thoughts/Summary

Most investors are maintaining a "soft landing" scenario as the base case for the global economy over the next few quarters. However, growth expectations between the major regions around the globe could be a bit different in 2025 vs 2024. We expect growth in the U.S. economy to cool down some in 2025, while it should pick up in the Eurozone, the U.K., and Japan. On the Emerging Markets front, the pace of growth will most likely fall in China and India, while accelerating in Latin America, parts of the Middle East, and in South Africa. We expect the U.S. Fed and the ECB to continue to lower interest rates over the next year as inflation readings continue to fall. The BOE will probably be slower to trim interest rates as core inflation is proving to be stickier in this region. Corporate earnings growth looks decent to us going forward with expected growth outside of the U.S. surprisingly strong. Most of the global employment data points look strong to us and should foster an environment for a decently strong consumer. Global equity market valuations remain attractive to us when considering the projected earnings growth and free cash flow generation. These points could push equity markets higher in the coming months. We would expect U.S. equities to outperform global equities as Trump's policies appear to favor the U.S., which is not much different than his previous presidency.

We continue to sell out-of-the money calls on the Emerging Markets Index to bring in some income, as option premiums remain attractive. Our current allocation to Emerging Market equities is approximately 3.0% of total assets and approximately 11.5% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios for a total international equity exposure of approximately 14.5%. This is nearly at our target allocation within our investment policy statement. *(Credit is given to the following entities for charts provided: RIMES, Capital Group, Fox News, Deutsche Bank, IMF, ISM, Markit, S&P Global, Macrobond, Fidelity Investments, Factset, Eagle Asset Mgmt.)*

Fiscal Policy

The Dollar's Dilemma: Trade Wars, Capital Flows, and America's Coming Policy Shift

By Michael McNair

Intro

Donald Trump's return to the presidency in 2025 will likely mark a decisive shift in US trade policy, but not in the way most analysts expect. While markets are focused on the prospect of higher tariffs and increased trade tensions, we believe the new administration's approach will be more sophisticated and potentially more effective than Trump's first-term policies.

The key personnel choices, particularly VP-elect JD Vance and Treasury Secretary nominee Scott Bessent suggest an administration that understands the true mechanics of global trade imbalances. Unlike the previous focus on bilateral trade deficits and tariffs, there are indications that policy may target the root cause of persistent US trade deficits: excessive foreign capital inflows.

Both Vance and Bessent have demonstrated a nuanced understanding of global trade dynamics that goes beyond conventional wisdom. Vance has shown familiarity with modern trade theory that emphasizes the role of capital flows in driving trade imbalances. In a March 2023 exchange with Federal Reserve Chair Jay Powell, he questioned whether the dollar's reserve currency status acts as "a massive subsidy to American consumers but a massive tax on American producers."

Bessent, a veteran global macro investor, has explicitly argued for a different approach than Trump's first term. In Key Square's January 2024 Investor Letter, he wrote that Trump will likely pursue a weak dollar policy rather than implementing tariffs, noting that "Tariffs are inflationary and would strengthen the dollar--hardly a good starting point for a US industrial renaissance."

This shift in approach matters because previous attempts to address US trade imbalances have failed largely due to a fundamental misunderstanding of what drives them. The conventional view that US trade deficits reflect American overconsumption or lack of competitiveness misses a crucial point: in today's global financial system, capital flows drive trade flows, not vice versa. The persistent US trade deficit is primarily a symptom of excessive foreign demand for US financial assets, not American consumer behavior or trade policy.

In this report, we examine why targeting capital flows rather than trade flows could prove more effective at addressing global imbalances. We explain why attempts to reduce the trade deficit through tariffs alone are likely to backfire, and why a coordinated approach to managing capital flows might succeed where previous policies have failed. The implications for currency markets, asset prices, and global trade flows could be profound.

Understanding Global Trade Imbalances: The Balance of Payments Framework

To understand why the new administration's approach to trade policy might succeed where previous attempts have failed, we first need to examine how international trade and capital flows actually work. Most analysis focuses solely on the flow of goods and services between countries. However, this view captures only half the picture.

International transactions are part of a larger system that includes two types of flows: trade flows (the exchange of goods and services) and capital flows (the exchange of financial assets like stocks, bonds, and property). These two flows are inextricably linked through what economists call the balance of payments, which can be expressed in a simple but powerful equation:

Trade Account* = Capital Account

*The technical BoP identity is: current account = capital account, but we are using “trade account” in place of the “capital account” for simplicity. It should be noted that the current account differs slightly from the trade account – a fact we can ignore for our discussion.

Why does this relationship hold? The answer lies in the simple fact that when foreigners acquire U.S. dollars, they can only do two things with them:

1. Buy U.S. goods and services (affecting the trade account)

2. Buy U.S. financial assets like stocks, bonds, or real estate (affecting the capital account)

Some might argue there's a third option - using dollars to buy commodities or assets from other countries. However, this merely transfers the dollars to new holders who face the same two choices. Eventually, all dollars must return to the U.S. to purchase either goods and services or financial assets.

The balance of payments accounting identity tells us that any change in one side of the equation must be matched by an equal and opposite change in the other. For example, when Korean pension funds invest $1 billion in U.S. stocks, all else equal, U.S. net exports must decrease by $1 billion and Korean net exports must increase by $1 billion - despite this transaction having no direct connection to trade in goods and services.

This framework helps explain why many conventional approaches to reducing the U.S. trade deficit have failed. When we focus solely on trade flows - through measures like tariffs or export promotion - we ignore the powerful role that capital flows play in driving trade outcomes. In fact, in today's global financial system, it's often capital flows that determine trade flows, rather than the other way around.

One of the fundamental misunderstandings about trade imbalances—particularly why China runs a persistent trade surplus while the US runs a persistent trade deficit—is the assumption that these imbalances are driven by one country's inherent production cost advantage over the other.

While production cost advantages do exist, they are not supposed to persist indefinitely in a properly functioning global trading system because trade imbalances should trigger self-correcting mechanisms that reverse relative production cost advantages.

In a properly functioning global trade and capital flow regime, persistent imbalances would self-correct. When a trade surplus country experiences excess demand for its goods and services, this should cause either its currency to appreciate or its relative inflation rate to rise. Both mechanisms increase the production costs of the surplus country relative to its trading partners, eventually reducing the surplus and rebalancing trade flows.

The critical question to ask is: Why haven't currency values adjusted to rebalance the system? Why has the trade surplus currency (e.g., China's renminbi) failed to appreciate relative to the trade deficit currency (e.g., the U.S. dollar)?

Once you understand that this lack of currency adjustment is a central feature of how the global trading system is supposed to work, you begin to see why the system is broken.
The reason the rebalancing mechanism has failed to operate effectively, and persistent trade imbalances have persisted for the past 40 years, is due to a fundamental distortion in the demand for currencies.

There are two distinct drivers of currency demand:

1) Demand for goods and services (trade flows), which typically reflect the underlying dynamics of comparative advantage and trade balances.

2) Demand for financial assets (capital flows), which arises from the preference for holding or investing in a particular country's financial instruments.

In today's financial system, it's this second source of demand - the desire for U.S. financial assets - that has effectively short-circuited the natural currency adjustment mechanism. Despite decades of large trade deficits, which should have led to dollar depreciation, the U.S. dollar has remained strong because of overwhelming foreign demand for U.S. financial assets.

The overwhelming demand for U.S. financial assets reflects structural features of the global economy, particularly policies in surplus countries that generate and export excess savings. These policies systematically suppress household income and consumption, forcing domestic savings rates far above what's needed for domestic investment.

Consider China, where households retain the lowest share of GDP ever recorded for a large economy. This isn't cultural thrift - it's the result of policies that transfer income from households to the corporate sector through currency undervaluation, financial repression, and weak social safety nets. The excess savings generated by these policies must be exported, primarily to the U.S. financial system.

This capital flow into U.S. markets comes through two channels:

First, public sector flows dominated in the 2000s and early 2010s as Asian central banks, led by China, accumulated massive dollar reserves. This policy-driven accumulation prevented natural currency appreciation that would have corrected trade imbalances.

More recently, private capital flows have taken center stage. As surplus countries generate savings far beyond domestic investment opportunities, private investors seek returns in U.S. markets. This shift from public to private flows hasn't changed the fundamental dynamic - surplus countries still export their excess savings, forcing the U.S. to run corresponding trade deficits.

These "beggar-thy-neighbor" policies effectively export unemployment and weak demand to deficit countries while preventing natural rebalancing through currency adjustment. The U.S., with its deep and open financial markets, has become the primary absorber of these excess savings, explaining the persistence of its trade deficits and decades of dollar overvaluation.

Capital Account Dominance: The Tail Wagging the Dog

Understanding why currency adjustment hasn't occurred requires examining how the nature of global financial flows has fundamentally changed over the past century. In the era when tariffs were the primary tool of trade policy - think of the infamous Smoot-Hawley tariffs of 1930 - trade flows dominated international transactions. The capital flows that did exist were primarily tied to trade financing, essentially facilitating the exchange of goods and services.

Today's world looks radically different. Starting in the 1980s, global capital flows exploded in volume and complexity, driven by financial deregulation, the elimination of capital controls, and innovations in financial markets. By the early 2000s, daily trading volume in global foreign exchange markets had grown to more than 100 times larger than daily international merchandise trade.

This transformation means that capital flows, not trade flows, now dominate in determining exchange rates and trade balances. While trade negotiators continue to focus on tariffs and market access, the real action is in the massive flows of capital seeking returns across global financial markets. These flows dwarf the impact of changes in trade policy, which helps explain why traditional trade tools like tariffs have become less effective at addressing trade imbalances.

This understanding of how capital flows dominate trade flows isn't merely theoretical - it explains why many trade policies fail to achieve their intended effects. During Trump's first term, we predicted that tariffs alone would fail to reduce the U.S. trade deficit. In fact, we argued they would likely increase it. This is exactly what happened.

Why? Because tariffs triggered two responses that increased demand for U.S. financial assets. First, heightened global economic uncertainty drove safe-haven flows into U.S. markets. Second, foreign central banks loosened monetary policy in response to tariffs, widening interest rate differentials and attracting yield-seeking capital into U.S. bonds. This surge in capital flows into the U.S. forced an even larger trade deficit through the balance of payments mechanism we've described. The policy achieved the opposite of its intended effect.

This also highlights why focusing exclusively on trade-account measures like tariffs in Trump's second term would likely fail again. When faced with tariffs, trading partners have numerous ways to counteract these measures that go well beyond simple retaliatory tariffs. For example, monetary policy loosening can trigger currency depreciation via capital outflows that offset trade effects

The key insight is that in today's financially integrated world, any policy that focuses solely on trade flows while ignoring capital flows is likely to be ineffective or counterproductive. This suggests that successful trade policy must address both sides of the balance of payments equation.

The Politics of Capital Flows and Why Politicians Focus on Tariffs

The administration's public focus on tariffs rather than capital flow measures reflects political reality. Trade deficits and tariffs are concepts voters understand intuitively. Capital flows and balance of payments adjustments are not.

Most Americans, including policymakers, believe the U.S. needs foreign capital to fund its spending habits. The conventional wisdom holds that we're fortunate foreigners are willing to buy our debt. However, the evidence shows this gets the causality backward.

If the U.S. were truly dependent on attracting foreign capital to fund excessive spending, we would see two clear signs:

1. U.S. financial assets would underperform as we competed for scarce foreign capital

2. The dollar would weaken as our need for external funding grew

Instead, we see the opposite. U.S. financial assets have been among the world's best performing, and the dollar has remained exceptionally strong despite decades of trade deficits. This pattern is precisely what we'd expect when foreign demand for U.S. financial assets drives trade deficits, not the other way around.

History provides clear examples of countries that genuinely needed to attract foreign capital to fund trade deficits. They invariably faced weak currencies and poor asset returns, having to offer substantial yield premiums to entice foreign investors. The U.S. experience could not be more different.

While this reality makes capital account measures potentially more effective than tariffs, it also makes them harder to sell politically. Trump's rhetoric focuses on the more easily understood trade restrictions, even as his team appears to grasp the deeper dynamics at play.

Policy Options and Likely Outcomes

While markets remain focused on the prospect of tariffs, we expect a more sophisticated strategy that targets the root cause of trade imbalances: excessive capital inflows.

The administration has two broad paths available: negotiated adjustment through what we might call a 'Mar-a-Lago Accord', or unilateral action through capital flow restrictions. Both approaches would mark a decisive shift from previous policies that focused solely on trade flows.

The Mar-a-Lago Accord Scenario

Our base case envisions the administration pursuing coordinated adjustment with major trading partners, particularly China. Like the 1985 Plaza Accord, which engineered a major realignment of global currencies, this agreement would aim for orderly appreciation of surplus countries' currencies against the dollar.

Several factors make this approach likely. First, key administration officials, particularly Treasury Secretary nominee Scott Bessent, understand that currency adjustment rather than tariffs offers the clearest path to restoring U.S. manufacturing competitiveness. Second, the administration holds significant leverage through its ability to restrict foreign access to U.S. financial markets - a threat made credible by the sophisticated understanding of capital flows demonstrated by officials like Vice President-elect Vance.

The mechanics would likely involve agreed targets for currency appreciation combined with commitments from surplus countries to boost domestic demand. For China, this would accelerate its stated goal of transitioning from export-led to consumption-driven growth. While previous administrations have sought similar commitments, they lacked credible enforcement mechanisms. The threat of capital flow restrictions would provide this leverage.

Unilateral Action Scenario

If negotiations fail to produce meaningful adjustment, we expect the administration to move toward direct measures targeting capital inflows. The historical precedent exists - until 1984, the U.S. maintained a 30% withholding tax on foreign interest income. The elimination of this tax played a crucial role in enabling the explosion of global capital flows we've witnessed since.

Capital flow restrictions could take several forms:

1) Reinstating withholding taxes on foreign interest income
2) Taxes on foreign purchases of U.S. financial assets
3) Direct limits on foreign ownership in certain sectors

The effectiveness of these measures stems from a fundamental asymmetry in global trade: surplus countries must find somewhere to send their excess savings. While they can retaliate against tariffs through various means, they have far fewer options when faced with restrictions on their ability to export capital.

Consider China's position. Its economic model generates savings far exceeding domestic investment opportunities. These savings must be exported somewhere, and the U.S. financial system, with its depth and sophistication, has been the primary destination. If this outlet is restricted, China faces difficult choices: allow currency appreciation, accept higher unemployment as excess savings can't be exported, or undertake painful domestic reforms to boost consumption.

Market Implications

Either scenario - negotiated or unilateral adjustment - would have significant implications for financial markets, though perhaps not in the ways many expect.

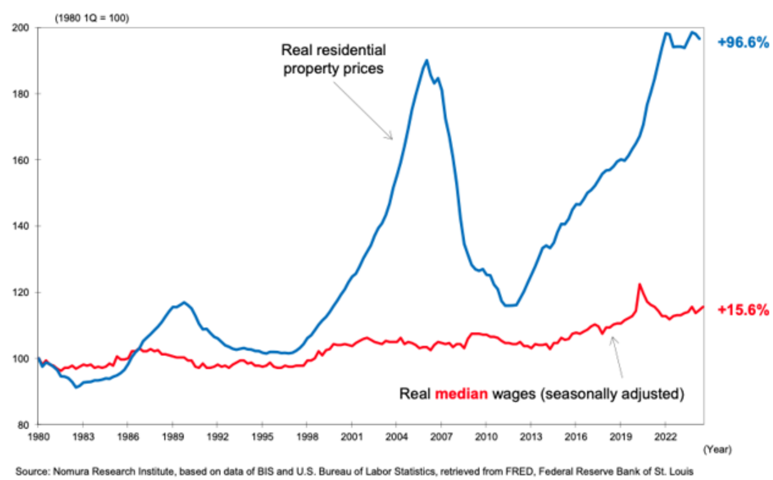
While conventional wisdom suggests reduced foreign buying would drive bond yields significantly higher, this view misunderstands what drives bond yields. Treasury yields are primarily determined by the expected path of future Federal Reserve policy rates, not by foreign demand. Japan provides a clear example - despite decades of reduced foreign buying and even active selling of Japanese government bonds, yields have remained low, primarily reflecting Bank of Japan policy.

The more significant impact would likely be felt in currency markets, where the dollar would depreciate particularly against Asian currencies. This adjustment would be necessary and intended - it's the mechanism through which trade competitiveness would be restored.

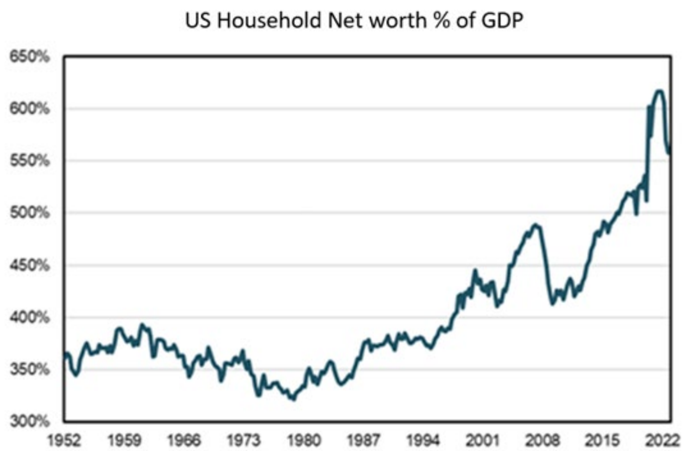
Equity markets would face a complex adjustment. While a weaker dollar would benefit U.S. exporters and companies with significant domestic manufacturing operations, reduced foreign capital flows could affect overall market liquidity and valuations. Sectors and companies would likely experience divergent outcomes based on their position in global supply chains and their reliance on foreign versus domestic markets.

Real estate markets, particularly in major cities that have attracted significant foreign investment, could face more direct pressure as international capital flows diminish. Commercial real estate, already challenged by post-pandemic shifts in work patterns, could be particularly vulnerable to reduced foreign buying.

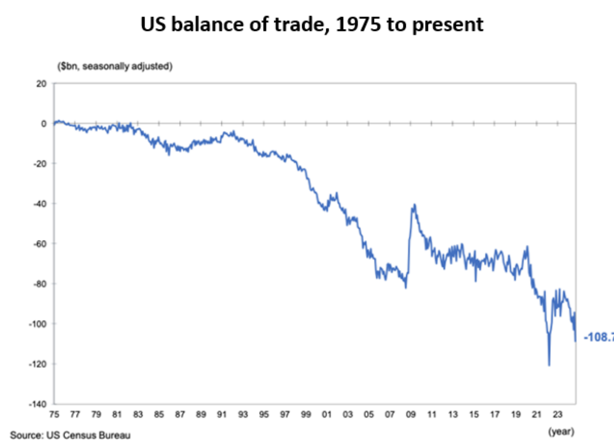
"Real" (inflation adjusted) Residential Real Estate Prices and Wages



As Richard Koo recently noted, "What is happening in the stock market may not affect the living standards of the people directly, but inflation-adjusted housing prices, which have a direct impact on household finances, have soared 96.6%. The fact that the real wages of the ordinary Americans seeking to buy these houses have risen by only just over 15% makes it clear in many senses that their standard of living has declined. It should not be surprising that they are so unhappy with the current system."



Since the early 1980s, U.S. household net worth has soared from around 350% of GDP to over 600%. This dramatic rise coincided with two transformative shifts in the global economy: the explosion in cross-border capital flows and the emergence of persistent U.S. trade deficits.



The timing is no coincidence. When foreign capital flows into U.S. financial markets but doesn't purchase American goods and services, it must instead buy existing assets - stocks, bonds, and real estate. Four decades of this persistent foreign buying has inflated asset values far above their historical relationship with the underlying economy.

If global trade imbalances reverse through the policies we've discussed, this ratio would likely begin normalizing - not necessarily through falling asset prices, but through faster GDP growth relative to asset values as U.S. manufacturing and exports revive. This rebalancing could be gradual under a negotiated adjustment or more abrupt if capital flow restrictions are imposed unilaterally.

Conclusion

The coming shift in U.S. trade policy reflects a deeper understanding of how modern global finance works. While markets remain focused on tariffs and trade restrictions, the real action will likely center on managing capital flows that have prevented natural economic adjustment for decades.

The new administration appears to grasp what previous ones missed: in today's financial system, trade imbalances persist because massive capital flows overwhelm traditional trade relationships. The U.S. runs persistent deficits not because it consumes too much or produces too little, but because it absorbs too much of the world's excess savings.

Policy success will require addressing this root cause. Either through negotiated adjustment - a Mar-a-Lago Accord - or unilateral capital flow restrictions, the goal is to reduce foreign purchases of U.S. financial assets and increase their purchases of U.S. goods and services.

The transition could be disruptive, but continuing current arrangements has become unsustainable. Surplus countries must eventually accept a reduction in their ability to export capital to U.S. financial markets. The U.S., as a deficit country, holds more leverage than many realize in forcing this adjustment.

For investors, this shift has profound implications. The era of persistent dollar strength despite trade deficits may be ending. A more competitive dollar would help restore balance to the U.S. economy, reviving manufacturing while allowing a more natural relationship between financial markets and real economic activity. The alternative - continuing to absorb the world's excess savings while hollowing out domestic industry - has become politically and economically untenable.