All I Want for Christmas...
Is a Mid-cycle Reacceleration (in 2025)

'Tis the season for our annual holiday tradition!

Again, we challenged ourselves to determine what could be the single-most important catalyst to drive markets higher in the new year and put it atop our wish list for Santa Claus.

At the top of our Christmas wish list last year was the hope for a broad corporate earnings growth reacceleration beyond the market-leading, mega-cap tech companies known as the Magnificent 7: Apple Inc.; Microsoft Corp.; Amazon.com, Inc.; Alphabet Inc.; Nvidia Corp.; Tesla Inc. and Meta Platforms, Inc. A broader earnings reacceleration could have led to greater market breadth, yet market participation failed to return to the highs of the cycle in 2021 despite strong performance. We must have been on Santa's naughty list again this year, because while consensus expects S&P 500® earnings to grow 9.5% in 2024, more than half is expected to come from just the Magnificent 7.

Although 2024 kicked off with a consensus view full of optimism that the Federal Reserve (Fed) would soon begin aggressively cutting rates — by approximately 150-175 basis points (bps) in 2024 — dreams were dashed when inflation proved harder to beat than most expected. Instead, the Fed held off on rate cuts until September and made only 75 bps of cumulative cuts through November 30.

Additionally, manufacturing activity in the U.S. was sluggish throughout the year, and global economic growth, especially in China and the Euro Area, remained modest. This slow-growth environment presented a challenging backdrop for smaller, more cyclical or more value-oriented companies to thrive. Thus, a broad acceleration in earnings growth was unable to take flight.

While we hope last year's gift is merely lost in transit and arrives sometime next year, in the meantime, we have a new wish for Santa. With rate cuts finally underway, we're looking forward to seeing this monetary policy "recalibration" work its way through financial markets, and ultimately, into the U.S. economy. Accordingly, we have an ask for Santa that could serve as a broad market catalyst in 2025.

Topping our Christmas wish list this year is... a mid-cycle reacceleration! If we get our wish, monetary policy should play a smaller role for markets in 2025, allowing fundamentals such as earnings and valuations to come into focus, which would be a welcome change for investors.

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Christmas wish revival

Business cycle analysis is a key tenet of our investment process as it provides a framework to determine which investment styles, factors and other themes may drive near-term returns. Unfortunately, there is no red-nosed reindeer to guide us to the precise point in the business cycle, nor do we know how long each phase will last. And, while history may rhyme, no two business cycles repeat, making this component of our ongoing analysis critical.

Since late 2022, we believe the business cycle has been in the later innings of a slowing expansion phase, defined by:

- concentrated earnings growth among U.S. mega-cap stocks;
- leading economic indicators signaling a contraction in global manufacturing;
- strong services economy supported by strong U.S. wage growth; and
- sticky, but slowing inflation.

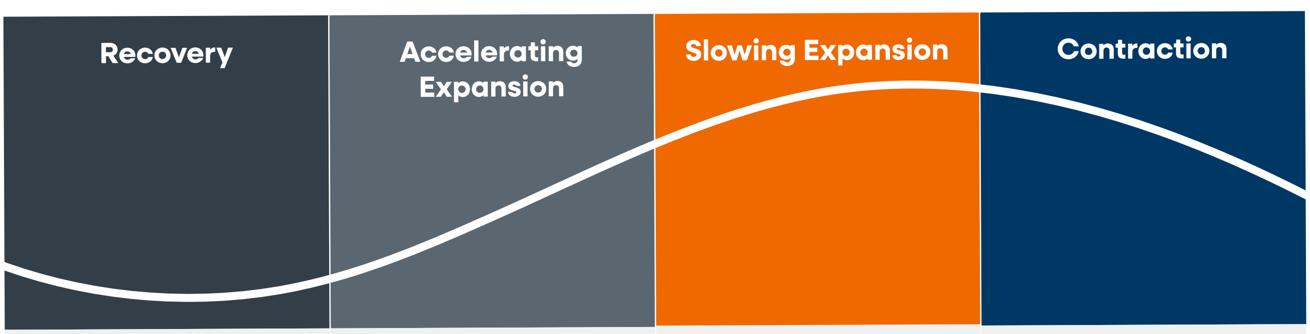
While the longevity of the slowing expansion phase overall has been surprising to many, our wish is for the global, synchronized shift toward looser monetary policy to guide a mid-cycle reacceleration. Like Santa's ski-jump ramp, we hope this falling business cycle inflects with the monetary policy pivot and begins soaring upward (**Figure 1**). While mid-cycle reaccelerations don't happen often, there have been examples in recent history, such as in the mid-1990s and 2017.

The Fed is comin' to town!

Global monetary policy easing is the gift we hope keeps on giving through 2025. Typically, central banks start easing policy when the business cycle is teetering on recession; however, this cycle appears to be a rare occasion in which fiscal policy (through deficit spending) and resilient U.S. consumer activity have been able to support a slowing expansion phase despite tight financial conditions. Just as the impact of monetary policy tightening had a lagged effect on the economy, likewise the impact of policy easing will take time to settle in.

Figure 1. Business Cycle Characteristics

We expect an extension of the slowing expansion and in time, an acceleration



Unemployment bottoming	Unemployment falling	Unemployment falling	Unemployment rising
Inflation low	Inflation rising	Wages rising	Inflation slows
Interest rates fall	Financial conditions accommodative	Financial conditions less accommodative	Interest rates decline
Credit growth moderates	Credit growth strong	Credit tighter	Credit tight
Confidence bottoms	Confidence rising	Confidence peaks	Confidence declines
Activity rebounds	Strong activity	Activity positive, but decelerating	Activity declines
Profits rebound	Profit growth strong	Profit growth slows	Profits fall

Source: PNC

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The economic impact of rate cuts may materialize sooner than the typical 12-month lag because unlike past easing cycles, many global central banks got a head start on cutting rates before the Fed. In March 2024, the Swiss National Bank became the first major central bank to cut interest rates, followed by the European Central Bank and the Bank of England, in June and August, respectively. Despite the Fed remaining "on pause" until September 2024, financial conditions have been easing for more than a year, due to global central bank actions and in anticipation of future Fed cuts. In our view, the countdown until the effects of monetary policy easing materialize has already begun and could show up as early as second quarter 2025 (**Figure 2**).

Rockin' around...the three pillars of our investment process

When it comes to navigating the market's path forward, our investment process is our North Pole, serving as our steadfast guide. Here is our quick take on where each of the three pillars of our process stand:

Business cycle

For the past two years, there has been a sharp divergence between manufacturing economic indicators, which have been in contraction and service economy indicators, which still show robust activity (**Figure 3**).

Currently, global manufacturing PMI data remains in contraction, and industrial metals prices from aluminum to zinc are lagging the proxy for domestic equities, the Russell 3000®, through November 30.

In early 2025, we expect the shift to looser global monetary policy to start supporting manufacturing. Evidence of that demand recovery should show up in leading economic indicators such as PMI data and improving industrial commodity prices.

Valuations

Through November 30, the S&P 500, S&P MidCap 400® and Russell 2000® are each on pace to outperform their positive returns from last year, a first since 2013. Notably, the S&P 500 is also on pace to deliver sequential-year returns of more than 20%, for

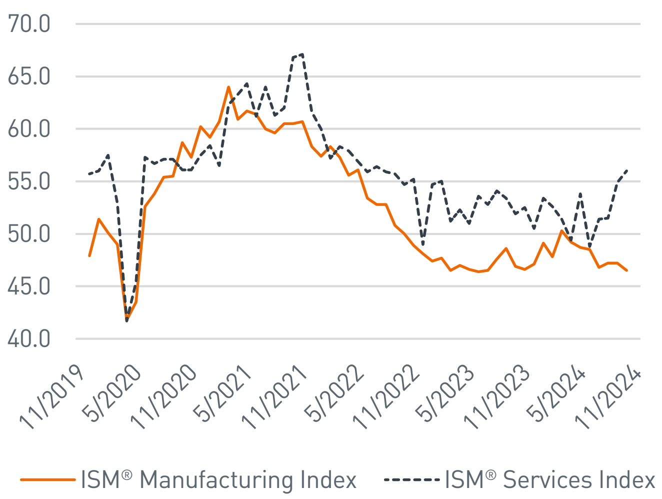
Figure 2. Goldman Sachs U.S. Financial Conditions Index

Easing financial conditions should begin to support the economy in early 2025

As of 11/30/2024. Source: Bloomberg L.P.

Figure 3. ISM® Manufacturing & Services Indices

The U.S. manufacturing economy has been in contraction for two years



As of 11/30/2024. Source: Bloomberg L.P.

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the first time since the late 1990s. As such, equities across most size and style factors are experiencing rising price-to-earnings (P/E) multiples despite relatively high interest rates.

We believe a mid-cycle reacceleration would boost earnings growth, and most asset classes are already expecting earnings growth in the double digits for 2025 (**Figure 4**). That outcome would allow the "E" to catch-up with the "P," helping valuations compress while still offering the potential for positive returns in 2025.

Technicals

With the S&P 500 reaching several all-time highs throughout 2024, and moving averages pointing even higher, it seemed like equity markets were overbought and due for a pullback.

Such a moment occurred during the summer, when the S&P 500 declined by more than 8.5% in three weeks. Despite being up more than 15% since the August 5 low, as of this writing, market breadth has yet to hit a year-to-date high, let alone return to 2021 levels.

We continue to believe that if the business cycle experiences a mid-cycle reacceleration, and earnings growth increases from 2024, then markets could finally experience broader leadership and breadth beyond the mega-caps — something that has not occurred over sustained periods during the past two years.

Will Fiscal Policy be the Grinch that Stole Christmas?

In addition to questions about the future path of monetary policy and inflation for investors heading into 2025, we cannot overlook the potential impact of fiscal policy. While speculative, abrupt changes in foreign trade could have a negative impact on economic growth and potentially drive inflation higher, akin to the rising price regime that occurred throughout much of 2022.

Also not to be overlooked is the outsized U.S. federal deficit. Since the first rate cut in September, longer-term yields have been on the rise (**Figure 5**), and if deficit spending widens further, it could drive them even higher. The fed funds rate has declined 75 bps, whereas the 10-year U.S. Treasury yield has risen 60 bps — perhaps the opposite reaction to what one might expect. Many investors have been assuming the yield curve would shift down and steepen once the

Figure 4. Multi-asset Class Consensus Earnings Growth Estimates

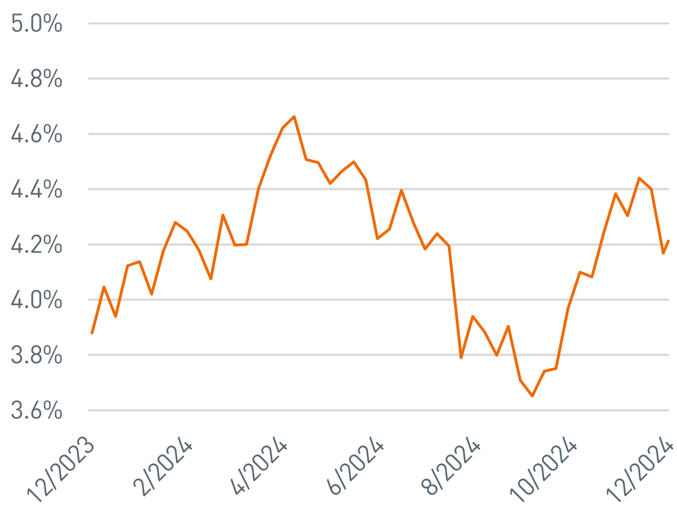
Strong outlook for earnings is a tailwind for stock prices

Index	2024	2025
S&P 500	9.1%	14.7%
S&P MidCap 400	-2.0%	13.2%
Russell 2000	-9.8%	41.4%
MSCI World ex USA	2.2%	7.8%
MSCI Emerging Markets	14.6%	13.5%

As of 11/30/2024. Source: Bloomberg L.P.

Figure 5. 10-year U.S. Treasury Yield

Long-term interest rates adjusting to potentially inflationary economic growth



As of 12/2/2024. Source: Bloomberg L.P.

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Fed began to cut its policy rate, and yet, the spread between the 10- and 2-year Treasury was only 2.1 bps as of November 30. We believe it's a reflection of the bond market's concern around deficits and debt levels; there's no easy policy off-ramp.

In addition, right out of the gate on January 1, the debt ceiling suspension is set to expire. The U.S. Treasury's estimated cash balance at the start of the year is expected to be approximately $700 billion, which should be a liquidity tailwind for financial markets as "extraordinary measures" may be used to fund the federal government until the debt ceiling is resolved. We believe once that occurs, yields should come back down, as they have been rising in response to some stress building in the system.

Even with rising yields, credit spreads for both investment grade and high yield fixed income keep tightening and are currently at new lows for the business cycle. We believe it's a reflection of the still-solid backdrop. While a material credit cycle has not formed, neither has a material default cycle.

Our base case is for a fed funds rate range of 3.50-3.75% by year-end 2025; however, the path to get there remains data-dependent. Our outlook is largely predicated on the expectation for monetary policy easing. If either inflationary trade policy or wider fiscal deficits leads to a change in monetary policy, it could limit the prospects of getting our Christmas wish in 2025. For now, we remain true believers that Santa will deliver the goods in 2025.

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