PNC

Rev the Engine

Driving Toward a Mid-cycle Reacceleration in 2025

In the nearly five years since the start of the pandemic, markets have traversed a long and winding road, full of hazards and pit stops along the way. The journey has been rife with uncertainty, but one thing is assured — we're not going back to where we came from.

We've closed the books on protracted periods of near-zero interest rates and nearly nonexistent inflation, meanwhile technology keeps marking new milestones and the evolution of geopolitics carries on. Likewise, the forces of monetary policy, fiscal policy and inflation continue to shape the road ahead for the business cycle and ultimately, financial market performance.

It's remarkable to think we began last year with such all-encompassing uncertainty; we posed questions about inflation, interest rates, consumer health, election outcomes, recession, market breadth, yields and earnings growth. Despite the lack of clarity, consumer strength persisted, financial markets forged ahead (and hit new highs), and the economy managed to avoid recession. With inflation largely reined in for now, Federal Reserve (Fed) interest rate cuts underway and the elections behind us, it's natural to wonder where we go from here. Does the economy have enough gas left in the tank to keep going?

The global, synchronized pivot toward monetary policy easing may be just the kickstart that the business cycle needs to rev up and accelerate from the tail end of the slowing expansion phase. Still, there remains the possibility that inflation reignites (for various reasons) or that changes in fiscal policy lead the cycle off course. However, should these macro forces remain supportive, we believe the market may finally see earnings growth broaden beyond just mega-cap tech — a necessary factor, in our view, for sustainable, positive performance.

In this edition of Strategy Insights, we explore how key market-shaping forces may be aligning to shift the business cycle into a new gear and drive a mid-cycle reacceleration in the business cycle in 2025.

Macro forces in the driver's seat

Monetary policy: On cruise control

The path of Fed policy has dominated the macro landscape for financial markets since tightening measures began in early 2022. Now that interest rate cuts have finally begun and the Fed and investors are largely on the same page about future rate cuts, much of the suspense should be in the past — with one important caveat, that the Fed keep cutting as expected.

In our view, there are two main ways these expectations could be disrupted. First, inflation could reignite, effectively upending the Fed's plans. Second, there remains the possibility that the Fed began loosening policy too late and the underpinnings of recession have already set in. To be fair, the Fed's track record largely aligns with the latter outcome. However, there have been some notable exceptions, such as in the mid-1990s, and we believe 2025 may also be one of the exceptions where monetary policy aids a mid-cycle reacceleration.

Like policy tightening, we expect policy easing to have a lagged effect on the economy — but the clock didn't start at the first Fed rate cut. Given the Fed signaled a pause in rate hikes in late 2023, and global central banks began to cut interest rates in the first half of 2024, we believe we could begin to see the benefit of looser monetary policy as early as the first quarter of 2025.

U.S. business cycle: Hit the gas

While consumers remain the ultimate driver of U.S. economic growth, we believe a mid-cycle reacceleration, catalyzed by easing monetary policy, will require strong participation from manufacturing industries. A growth rebound from increased manufacturing activity should help extend the slowing expansion phase of the cycle and stave off recession.

For the past two years, there has been a sharp divergence between manufacturing economic indicators, which have mostly been in contraction, and service economy indicators, which still show robust activity. Currently, the six-month average for global manufacturing Purchasing Manger Index (PMI) data remains in contraction and has been weakening for five months. Furthermore, industrial metals prices from aluminum to zinc are lagging our proxy for U.S. equities, the Russell 3000®, through year end.

The downstream impact of manufacturing on the U.S. economy is considerable. For example, automobile manufacturing relies on global supply chains, a robust service economy and healthy consumer spending, not to mention reasonable fuel costs. Therefore, when manufacturing is in contraction, it can tip the overall economy into a recession. The fact that manufacturing has been in a lengthy contraction and a recession has yet to occur illustrates to us the uniqueness of the post-pandemic cycle. Notably, we believe income growth has helped shield consumer spending from the burden of high inflation and restrictive monetary policy. In early 2025, we expect the shift toward looser global monetary policy to start supporting manufacturing and improve the outlook for leading economic indicators such as PMI and industrial commodity prices.

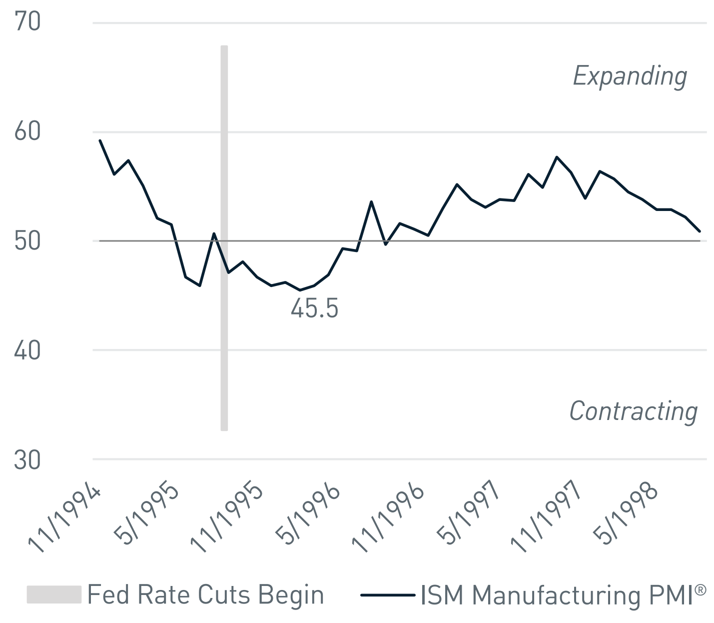
There is precedent for monetary policy supporting a shift in the business cycle and bolstering the manufacturing sector as recent as the mid-1990s. In 1995, the Fed was "on pause" for a mere three months between its last rate hike in March and its first rate cut in July (in contrast, the Fed was on pause 14 months in the most recent cycle).

In April 1995, the ISM® Manufacturing PMI® fell below 50 (indicating contraction) but recovered above 50 by August 1996 and remained in expansion for the next two years (**Figure 1**). The Producer Price Index (PPI) likewise rebounded in 1995, as did one of the most common industrials metals, steel.

Steel prices reached a peak in May 1995 and bottomed in February 1996, but by early 1997 were hitting all-time highs. The October 2024 PPI reading of steel prices showed a month-over-month acceleration, a feat that has only happened four times in the past two years. In contrast to our preference for a slowing Consumer Price Index, an accelerating PPI would be a welcome indicator that manufacturing activity is rebounding.

Figure 1. ISM® Manufacturing PMI®

1990s manufacturing PMI data bottomed six months after the first Fed rate cut



As of 12/31/2024. Source: Bloomberg L.P.

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Fiscal policy: Tinkering with the engine

With a change in political administration and heightened awareness of growing U.S. debt and deficit levels, we expect fiscal policy to be a focus for markets in 2025.

The deficit has been a material tailwind for the U.S. economy in recent years as it has been running at levels typically seen during, or shortly after, a recession. Although the deficit has improved from one-year lows, it currently stands at 7.1% of U.S. GDP, almost twice as wide as its 40-year average of -3.8% (**Figure 2**). We expect the deficit to become an economic headwind as it could pressure long-term interest rates higher and negatively impact long-term economic growth.

Financial markets have largely shrugged off growing deficit levels for decades; however, this indifference may be waning. For example, while the Fed has cut its policy rate by 75 basis points (bps) since September, the 10-year U.S. Treasury (UST) yield has increased approximately 90 bps. Likewise, the 5-year breakeven yield — a proxy for inflation expectations — has increased by nearly 40 bps over the same period. Many investors may have been assuming the yield curve would shift down alongside rate cuts; however, we believe what's happening reflects the bond market's concerns about deficits and debt levels.

Therein lies the risk of the deficit-inflation feedback loop: excessive borrowing typically leads to inflationary pressure, and ultimately, higher interest rates. Should the Fed continue cutting interest rates as expected, monetary policy easing should help alleviate pressure on the cost of debt service. However, should inflation remain elevated due to deficit levels, we expect it will continue to be a headwind for investors as long-term interest rates also remain elevated.

The start of the new year also brings the end of the debt ceiling suspension. Once the Treasury reaches its debt limit, it will need to rely on "extraordinary measures" and cash on hand until a solution is reached. Consensus estimates the Treasury had cash balance of approximately $720 billion as of January 1. At an average year's spending pace, the Treasury will exhaust these funds by August 2025. While debt ceiling uncertainty creates a headwind for markets, should the Treasury be forced to rely on funding from its general account, it would add liquidity to financial markets and serve as a tailwind. Overall, this uncertainty is likely contributing to rising yields; we expect yields to experience some relief once a resolution is reached.

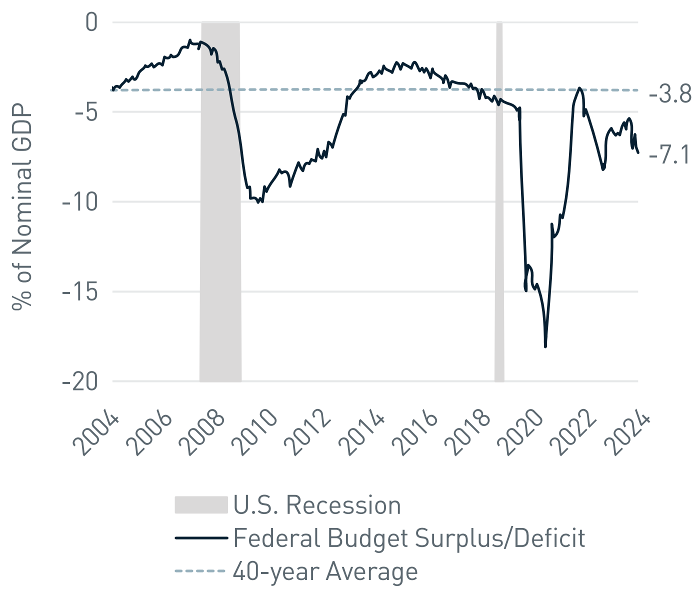
Even with rising yields, credit spreads for both investment grade and high yield fixed income keep tightening and are currently near lows for the business cycle. We believe this is a reflection of the still-solid backdrop. While a material credit cycle has not formed, neither has a material default cycle.

Last but not least among fiscal uncertainties is the potential for changes to U.S. trade policy, including the prospect of tariffs. While many consider tariffs inherently inflationary, we believe the reality is more nuanced depending on the situation. Targeted tariffs are less concerning, in our view, than a universal tariff policy as we believe the latter is more likely to add to inflation pressure.

Overall, we expect policy uncertainty may contribute to elevated market volatility in the months ahead but investors will likely adapt quickly as policy details are formalized, especially if economic growth remains resilient and inflation is contained.

Figure 2. Federal Budget Surplus/Deficit (% of GDP)

The federal deficit is impacting inflation and long-term interest rates



As of 12/31/2024. Source: Bloomberg L.P.

Rotating sector leadership: Overcoming roadblocks

Investor sentiment is already reflecting expectations for a potential mid-cycle reacceleration based on sector performance in late 2024. We believe sectors that are highly correlated to the U.S. economy, such as Energy, Financials and Industrials, could be positioned to perform well in the new year, contingent on supportive monetary and fiscal policy and an improvement in the business cycle for manufacturing.

For example, while mega-cap tech dominance continued in the post-election period, the Financials sector also managed to deliver a positive return through December 31. While Financials sector performance is partly a function of interest rate movements, in our view, it is also largely due to growing expectations for a pickup in capital markets activity in 2025. Activity slowed in 2024 as consensus expectations called for a mid-year slowdown or even mild recession. Should capital markets activity pick up in 2025 as expected, it should lead to improved loan growth and a resurgence in capital expenditures (capex) among traditional manufacturing industries and sectors.

To be clear, there was a steady flow of capital spending in 2024, it was just primarily from the mega-cap stocks within the Information Technology sector and internet-based stocks in Communication Services as these companies have continued to spend big on capex. For example, Microsoft Corp., a software company with 40% operating margins, spent $49 billion in capex over the trailing 12 months as of September 30; a large sum compared to the median S&P 500 company market capitalization of approximately $38 billion.

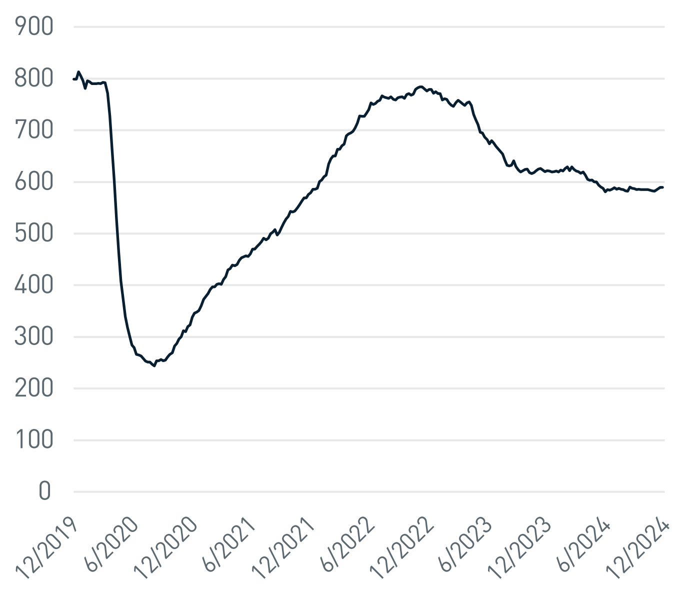
The days of mega-cap companies with capital-light balance sheets in the prior business cycle have transitioned to investing significant capex around artificial intelligence (AI) applications, data centers and cloud computing infrastructure. AI innovation should create tailwinds in other sectors such as Financials as capital markets activity picks up in 2025, as well as the Energy sector given the vast power needs and required buildout of supportive infrastructure.

While Energy sector stocks have been volatile since the pandemic, so too has its manufacturing activity. The traditionally capital-intensive Energy sector has seen capex demand decline since 2022, as measured by the Baker Hughes oil and gas rig count (**Figure 3**). Thus, while performance for the sector and the refining industry are still outperforming the S&P 500 since the start of the Russia-Ukraine war in February 2022, both are lagging materially in 2024. The refining industry in fact delivered a negative return in 2024.

One catalyst that could support a reacceleration in the Energy sector in 2025 is a change in stance from fiscal policy that encourages capex, which could lead to improving earnings growth. Since the 2024 U.S. election, the S&P 500 Energy Storage & Transportation industry is not only positive, but it also outpaced the S&P 500 through year end with a 4.0% return. In sharp contrast, the iShares Global Clean Energy ETF is down 14.9% for the same period.

Figure 3. Baker Hughes U.S. Oil & Gas Rig Count

Declining oil servicing activity has been a major contributor to manufacturing woes



As of 12/31/2024. Source: Bloomberg L.P.

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Inflation: Navigating uncertain terrain

There are two kinds of inflation: "bad" inflation, driven by supply chain bottlenecks and debt; and "good" inflation, the result of strong demand. While inflation throughout much of 2024 was of the good ilk, we remain cautious of the potential for bad inflation to reemerge in 2025.

It's challenging to distinguish between the two types in real time, and bad inflation is much less transitory than the latter. We expect 2025 will present a crossroads for inflation; does it continue slowing toward the Fed's 2% target or does an exogenous event lift prices again?

We can foresee two scenarios in which inflation reaccelerates, the first being fiscal policy. The second scenario could result from the Fed loosening policy too soon, allowing lingering inflation pressures to reignite.

In our view, the more likely sources of potential inflation increases could be housing prices or services, which have largely remained immune to monetary policy actions over the past several years. A less likely source is commodity prices as we do not expect a repeat of the commodity super cycle experienced during China's industrialization in the early 2000s.

No matter the source, reaccelerating inflation could present an immediate and serious headwind for financial markets as it would likely force the Fed to change course on monetary policy. This is not our base case for 2025, but it's a risk worth highlighting, nonetheless.

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Asset Class Outlook

What do financial markets have in store for investors in 2025?

Asset Class	View	Summary
Equity		
U.S. Equity	Very Favorable	The slowing expansion still favors quality stocks; a mid-cycle reacceleration could shift leadership toward stocks with a high correlation to U.S. economic growth
Developed International	Unfavorable	Geopolitical risks remain high, offering few near-term positive catalysts despite low absolute valuations
Emerging Markets	Neutral	Despite potential headwinds from possible trade policy changes, earnings growth for the index is expected to accelerate as most central banks are loosening policy
Fixed Income		
Investment Grade	Neutral	Interest rates remain tied to the path of inflation and economic growth, leaving income as the primary source of performance
High Yield	Favorable	Spreads remain tight due to easy financial conditions, and fundamentals look strong as corporate earnings are expected to rebound in 2025
Emerging Markets Debt	Favorable	Most constituents have a positive economic growth outlook and net-export countries should benefit from commodity price inflation
Municipal Bonds	Neutral	Valuations reflect current fundamental conditions and economic activity remains supportive
Alternatives		
Private Equity	Favorable	Capital markets activity should ramp up in 2025, creating opportunities for long-term investors
Private Debt	Favorable	Continued opportunities as traditional lending markets remain relatively tight
Private Real Estate	Neutral	The heterogeneity of real estate offers top managers the ability to generate meaningful returns for long-term investors
Hedge Funds	Favorable	Low correlations in 2024 should revert as macroeconomic themes could amplify the importance of diversification

Equity: Multi-lane highway

U.S. equity

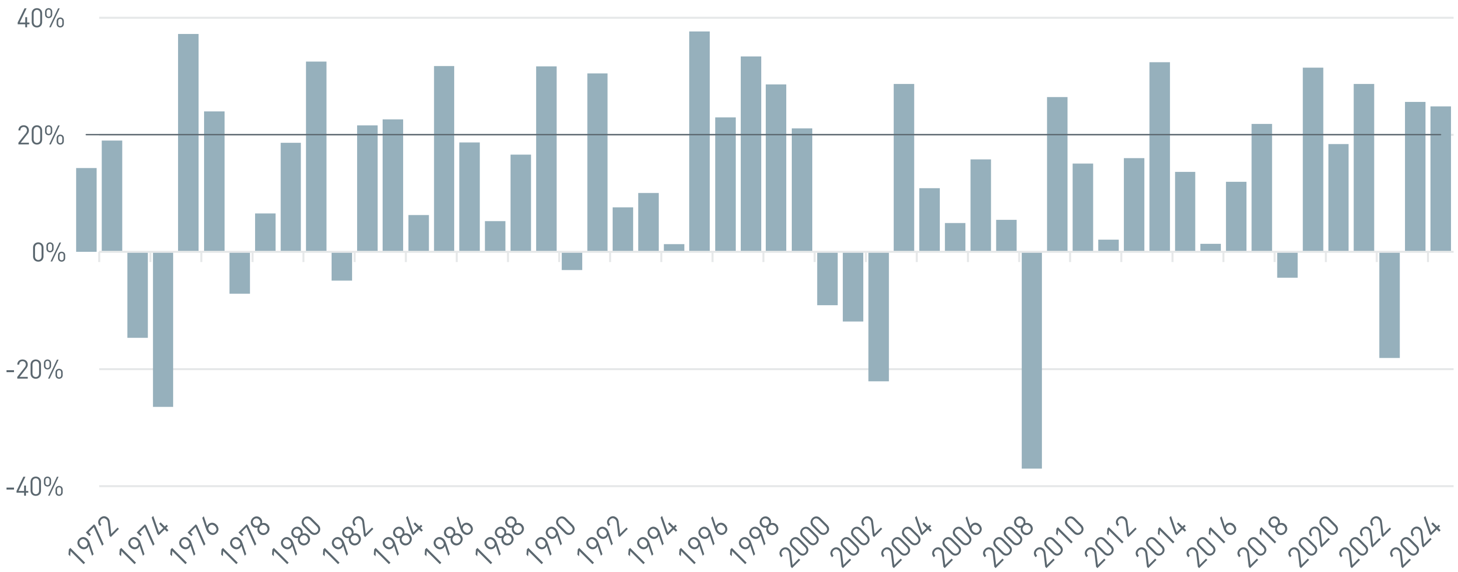
Our base case for U.S. equities in 2025 calls for an end to recent record-shattering returns. Unsurprisingly, it is rare for the S&P 500 to deliver sequential years of returns of more than 20%. Since 1970, this scenario has only occurred once — during the 1990s, from 1995-1998 (**Figure 4**). Even during that five-year bull market, the S&P 500 still experienced two pullbacks of more than 10%, in addition to a 19% correction in 1998. We continue to believe the biggest driver of market returns is the outlook for earnings, which we expect to improve in 2025.

Following a 9% expected earnings growth rate for 2024, consensus expects S&P 500 earnings to grow 15% in 2025. While it may be tempting to extrapolate this as an indicator of strong expected price performance in 2025, it's worth noting that most of 2024's return stemmed from multiple expansion (in anticipation of stronger earnings in 2025) and not earnings growth. Even more stark, multiples of smaller capitalization stocks increased in 2024 despite consensus expectations for S&P 400 MidCap® and Russell 2000® earnings to decline 2.0% and 13.4%, respectively. In both mid- and small cap, consensus expects earnings to rebound in 2025 by 12.8% and 44.4%, respectively.

Multiple expansion during 2024 lifted valuations to levels not seen since 2021 — a time when fiscal and monetary policy were providing significant market liquidity in the wake of the global pandemic. Three years later, forward earnings multiples for the S&P 500 are nearly the same, even excluding the 10 largest stocks by market capitalization, or when looking at the S&P 500 on an equal-weight basis.

Figure 4. S&P 500 Annual Total Returns

Past performance is a poor guide for forward-looking investors



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In 2025, we expect it will be challenging for earnings to catch up to price levels; however, if it did occur, markets may be able to deliver positive returns alongside valuation compression. It's a difficult but possible feat as multiples have contracted in 11 of the past 30 years, with more than half of those years posting positive calendar-year returns (**Figure 5**). Apart from 2021, every other year with positive performance and multiple compression had one key commonality — positive earnings revisions.

To contextualize today's environment, if the consensus earnings growth estimate for the S&P 500 is 14.5% for 2025, we see little room for positive earnings revisions barring some unforeseen fiscal stimulus, such as adjustments to corporate tax rates. In addition, growth stocks are expected to be the primary earnings driver, led by contributions from several non-tech sectors, such as Health Care, Energy and Industrials, which puts even greater emphasis on the need for a mid-cycle reacceleration (**Figure 6**).

We are optimistic that earnings growth will broaden in 2025, as the industries expected to experience significant earnings growth include the manufacturing juggernauts of aerospace, biotechnology and oil/gas exploration & production. Through December 31, 2024, those three industries are lagging the S&P 500. In our view, this implies some investor skepticism about those industries' ability to deliver on their earnings estimates in 2025. Therefore, we expect any upside surprises in 2025 to be well received.

Overall, as we enter 2025, we maintain a favorable view of the long-term U.S. growth outlook. As monetary policy helps ease financial conditions, we believe it will allow manufacturing activity to rebound, and in turn support the industries expected to lead earnings growth in 2025. Should leading manufacturing economic indicators show signs of a recovery, it would imply earnings revisions should turn positive for quality growth stocks in cyclical sectors and be yet another positive catalyst in 2025 (**Figure 7, page 10**).

Figure 5. S&P 500 Change in NTM P/E vs. Annual Return Result

Valuation compression does not always result in negative returns

Year	Multiple Contraction?	Positive Return?
2022	Yes	No
2021	Yes	Yes
2018	Yes	No
2011	Yes	Yes
2010	Yes	Yes
2008	Yes	No
2007	Yes	Yes
2005	Yes	Yes
2004	Yes	Yes
2002	Yes	No
2000	Yes	No

As of 12/31/2024. Source: Bloomberg L.P.

Figure 6. S&P 500 Earnings and Valuation Comparison by Sector

Non-tech sectors are expected to contribute to earnings growth in 2025

Sector	2025 Earnings Growth Estimate (%)	NTM P/E (x)	3-Year Avg NTM P/E (x)
Communication Services	15.2	19.4	17.1
Consumer Discretionary	12.1	28.6	24.9
Consumer Staples	5.5	20.8	20.3
Energy	3.4	13.6	11.0
Financials	9.1	16.6	13.9
Healthcare	20.5	16.6	17.4
Industrials	18.8	21.6	19.2
Information Technology	23.2	28.9	25.1
Materials	17.2	18.3	17.3
Real Estate	4.6	17.6	17.9
Utilities	9.0	17.3	17.9
S&P 500	*14.5*	*21.5*	*18.9*

As of 12/31/2024. Source: FactSet®. FactSet® is a registered trademark of FactSet Research Systems Inc., and its affiliates

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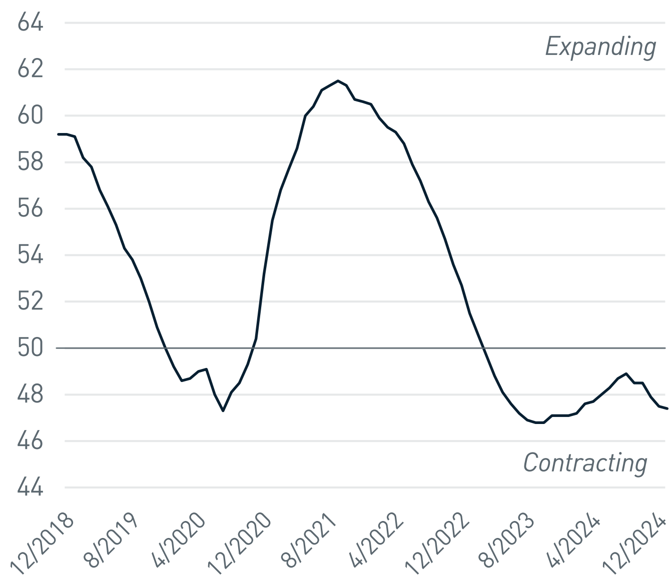
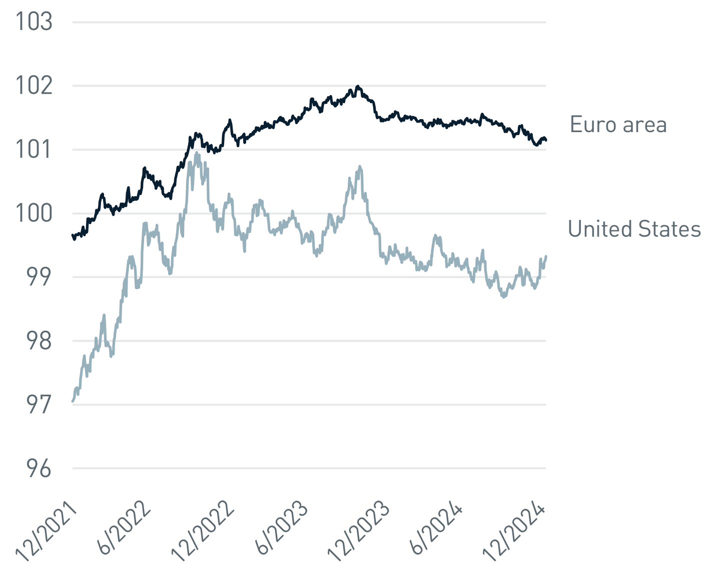
Figure 7. ISM® Manufacturing PMI® (6-month average)
A manufacturing rebound has been elusive



As of 12/31/2024. Source: Bloomberg L.P.

Figure 8. Goldman Sachs Financial Conditions Indices
Euro area financial conditions are tighter than in the U.S.



As of 12/31/2024. Source: Bloomberg L.P.

Developed international equity

We continue to have a negative bias toward developed international equity heading into 2025. While valuations are relatively low, inflation is slowing and major global central banks are loosening monetary policy, the earnings outlook remains clouded by a weak economic backdrop.

In the Eurozone, for example, the manufacturing PMI survey, a key leading economic indicator, has remained in contraction territory for more than two years. This is casting doubt on an already weak Eurozone economic recovery that is still reeling from an energy crisis that started in 2022.

We expect many of the same factors to impact the Eurozone in 2025 as the region continues to battle high energy costs relative to the United States, which is a significant headwind to consumer spending. Additionally, we believe fierce auto industry competition from China could challenge earnings growth, especially given the Industrials sector is the second-largest sector in the MSCI World ex USA Index at 16.2%, as of year end. In our view, the weak economic growth backdrop will further pressure the European Central Bank to continue cutting rates next year to support demand and further ease financial conditions and bank lending (**Figure 8**).

Consensus earnings growth rates for the MSCI World ex USA Index are approximately half those of the S&P 500, at 7.4% versus 14.7%, respectively. Thus, we believe the index's next-12-month (NTM) price-to-earnings (P/E) ratio versus the S&P 500 (13.9x vs. 21.5x, respectively) is justified given the weaker economic and earnings outlook. From November 6 (the day after U.S. elections) to December 31, 2024, the index not only lagged the S&P 500 by more than 500 bps, but it was also down over that period. In our view, this move implies expectations for potential fiscal policy changes that could hamper the already weak growth outlook for many developed countries and regions.

A potential change in foreign trade policy is a downside risk to an already fragile Eurozone, in our view, and also one that increases the risk of recession in the region. Although U.S. tariff changes may not have an immediate impact on Europe, renewed uncertainty around trade could maintain weak economic growth and thus, material, negative earnings estimate revisions could ensue. We

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believe Germany would be impacted most by potential tariffs on European autos as the United States is the country's largest trading partner outside Europe.

Japan, meanwhile, is on a different path relative to other developed international economies due to continued hawkish monetary policy from the Bank of Japan. We believe this hawkishness could present a headwind to equity returns in Japan in 2025. However, short-term interest rate differentials between the United States and Japan are set to narrow as the Fed continues cutting rates. That said, the impact it may have on the yen remains to be seen.

Because many companies in Japan are export-oriented, their earnings are sensitive to currency fluctuations. Since September 2006, the yen has exhibited an increasingly negative correlation to large-cap equities in Japan (**Figure 9**). Should the Fed cut its policy rate less than consensus expects in 2025, or should U.S. economic growth continue to surprise to the upside, we expect the U.S. Dollar Index to strengthen. A stronger dollar, in our view, would remain a headwind for developed international equities.

Emerging markets equity

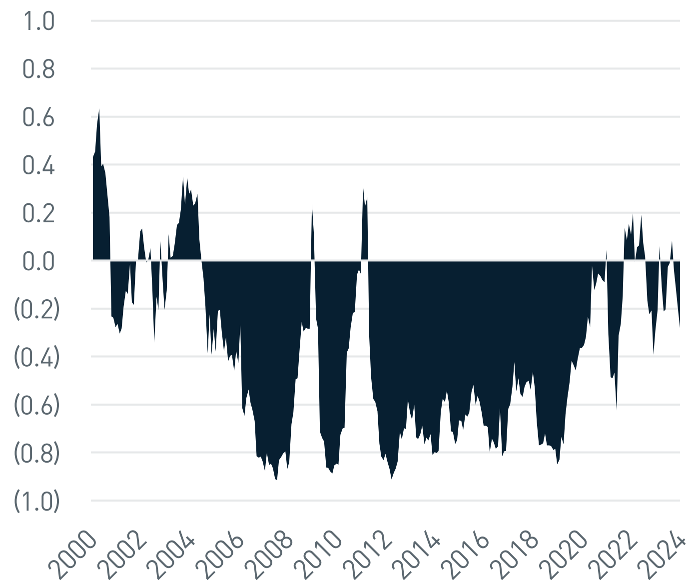
Given trade policy uncertainty and lackluster domestic demand in China, we anticipate increased volatility for emerging market (EM) equities in 2025. That being said, we favor EM relative to developed international due to stronger fundamentals.

While tariff policies are widely expected to shift in some form, should these changes result in increased tariffs on imports from China, the potential impact on earnings estimates would be a material headwind for EM equities in the short run given China's 24.4% weight in the MSCI EM IMI Index. However, we consider this a short-term risk as key bilateral-trade partners for many EM economies have been diversifying in recent years (**Figure 10**).

We believe supply chain issues stemming from the pandemic have led to greater trade-partner diversification among EM economies. Furthermore, the United States does not play an overwhelming role. For example, among all EM economies, as of 2023, only South Korea lists the United States as its largest trading partner. China's primary trading partner was Russia, which increased

Figure 9. Rolling 12-Month Correlation of the JPY/USD versus the MSCI Japan Index

The yen has exhibited a strong negative correlation to the equity market in Japan



As of 12/31/2024. Source: Bloomberg L.P.

Figure 10. Key Trading Partners for 5 Largest MSCI EM Index Constituents, Change in Exports 2022-2023 ($ billions)

We believe U.S. tariff policies will have little impact on most EM economies

China	India	South Korea	Brazil	Saudi Arabia
Top net increases in exports by country				
Russia $35.18	Netherlands $9.07	U.S. $0.01	China $14.90	
	Israel $3.65	Poland $0.00	Mexico $1.52	
	U.A.E. $3.56	Hungary $0.00	Argentina $1.37	
Top net decreases in exports by country				
Netherlands $17.00	Nepal $1.55	Taiwan $0.01	India $1.62	South Korea $9.28
Hong Kong $24.26	Bangladesh $3.91	Vietnam $0.01	Spain $1.89	India $11.65
U.S. $75.54	China $5.95	China $0.03	Iran $1.99	China $13.43

As of 12/31/2024. Source: FactSet®

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imports from China by $35 billion from 2022 to 2023, while exports from China to the United States dropped $76 billion year over year. India's largest trading partner in 2023 was the Netherlands, and its smallest was China. Thus, although changes in U.S. tariffs could impact bilateral trade, we believe the effect will be mitigated by enhanced diversification.

We believe 2025 will provide a supportive economic backdrop for most EMs as many countries seek to boost domestic demand by loosening monetary policy (**Figure 11**). Many EM economies have already experienced a monetary policy recalibration as the key benchmark rates for most EM central banks have been cut alongside slowing inflation.

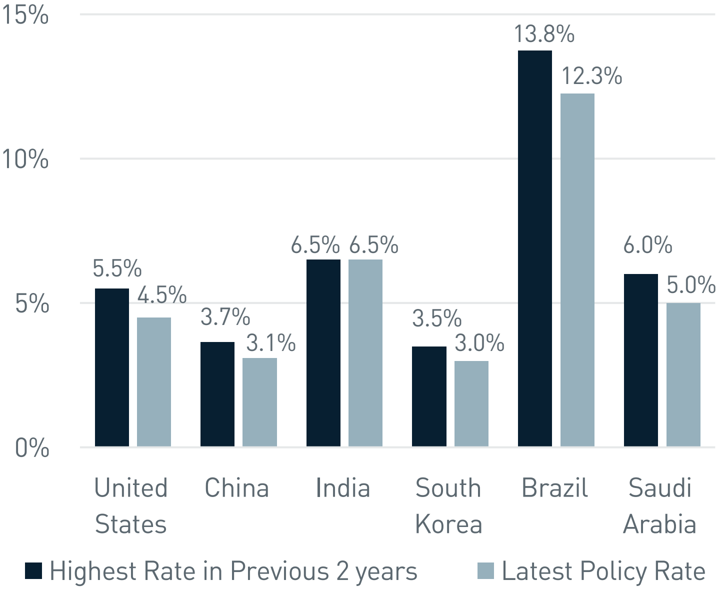
Less than two weeks after the Fed began to ease policy in September 2024, the People's Bank of China notably pledged to ease liquidity constraints for banks, reduce policy rates and take measures to propel its real estate sector. These announcements sparked a sharp equity market rally; however, they have yet to materialize into increased domestic consumption. As a result, we continue to believe that without additional fiscal stimulus in the form of direct support for consumers, a material rebound in economic growth will be difficult (**Figure 12**).

In contrast to China, the second-largest constituent in the EM index, India, has the highest NTM P/E ratio of the index, despite maintaining its benchmark rate at 6.5% since February 2023. Like China, the Reserve Bank of India cut the bank cash reserve ratio at its December 2024 meeting to inject liquidity into its banking system. Among the largest EM constituents, Brazil remains an outlier on monetary policy as its inflation has been rising in recent months.

Given the easing cycle across most EM central banks, the earnings outlook for EM continues to look favorable with a consensus growth rate estimate of 13.6% for 2025. The largest growth drivers are expected to be South Korea, Brazil and India. Therefore, we believe it is important to distinguish that while the MSCI EM Index NTM P/E is a relatively low 11.8x versus the MSCI World ex USA Index at 14.1x, this is largely due to China.

Figure 11. EM Monetary Policy Easing

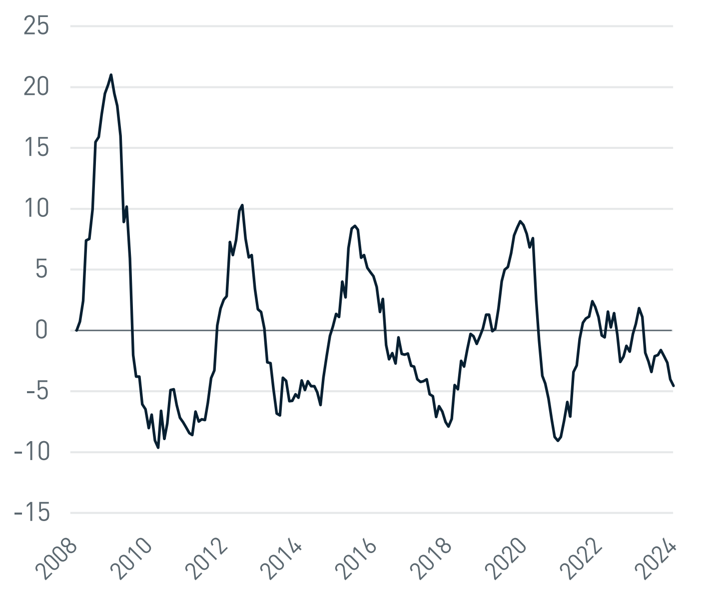
Most EM central banks are in a dovish policy mode



As of 12/31/2024. Source: Bloomberg L.P.

Figure 12. Bloomberg Credit Impulse Index* - China, 12-month Change

Without fiscal stimulus, China's growth outlook is subdued



**The Bloomberg Credit Impulse Index represents the percentage of new loans in GDP, a measure of the credit cycle.*
As of 12/31/2024. Source: Bloomberg L.P.

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Fixed income: Taking the scenic route

While it may seem like global monetary policy easing should pave the way for positive fixed income returns in 2025, we urge investors to consider the fixed income environment amid a potential mid-cycle reacceleration. In our view, a pickup in economic growth would likely necessitate a shift upward in longer-term interest rates.

In fact, since the Fed cut its policy rate on September 18, 2024, the 10-year UST yield increased 90 bps through year end. Likewise, the Bloomberg U.S. Aggregate Index (Agg) declined 3.3% during this period.

Considering the Agg remains in its longest drawdown on record, it is imperative to understand that the relationship between fixed income and Fed policy is less correlated than investors may appreciate. Instead, the path of interest rates — and ultimately, fixed income returns — are much more intertwined with the relationship between the economic and inflation outlook.

The current consensus U.S. GDP growth estimate is 2.1% in 2025 — a decline from the 2.7% estimate for 2024. Should GDP instead accelerate in 2025, we would expect to see the 10-year UST yield move higher as well.

Our fixed income outlook also reflects our observations about U.S. debt and deficit levels. As of this writing, the ratio of U.S. debt to GDP sits at its highest level in history at 120% and has been above 100% since the pandemic. For fixed income investors, a rising debt-to-GDP ratio is important because it indicates the U.S. Treasury is issuing USTs at an accelerating pace. Demand from investors, both foreign and domestic, needs to increase accordingly, otherwise the elevated debt-to-GDP ratio is another headwind that could pressure long-term interest rates higher.

In this section, we take a deeper dive into our outlook for the three sectors of the Agg — USTs, corporate bonds and securitized loans — as well as other fixed income sectors including high yield, EM debt and municipals.

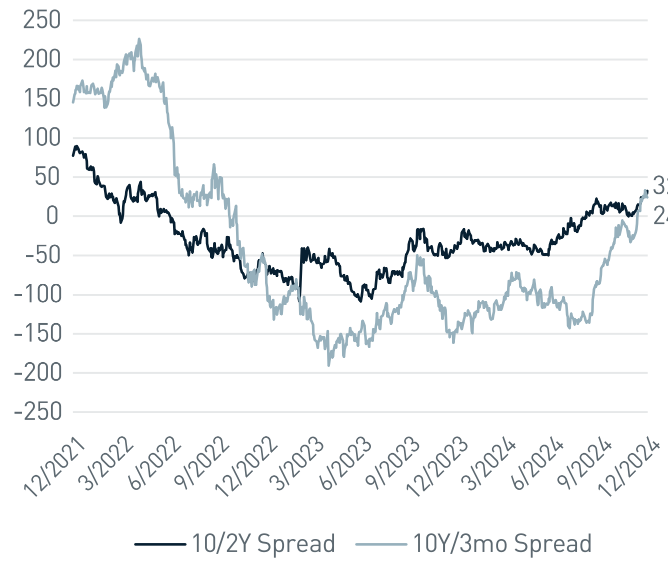
U.S. Treasuries

Shifting monetary policy and an environment of slowing economic growth have shaped the UST market and our outlook for the year ahead. In 2025, we expect the UST market to be influenced by a steeper yield curve, positive term premiums and an expected increase in short-term bill issuance.

After breaking the record for the longest period of yield curve inversion (when short-term interest rates are higher than long-term rates) in history, parts of the yield curve began normalizing during the latter half of 2024. However, despite this shift and the beginning of rate cuts by the Fed, the 10-year to 3-month T-bill yield curve remains far from steep at 33 bps through year end (**Figure 13)**.

Figure 13. U.S. Treasury Yield Curve Spreads

Yield curve steepening has a long way to go before it becomes a material tailwind for investors



As of 12/31/2024. Source: Bloomberg L.P.

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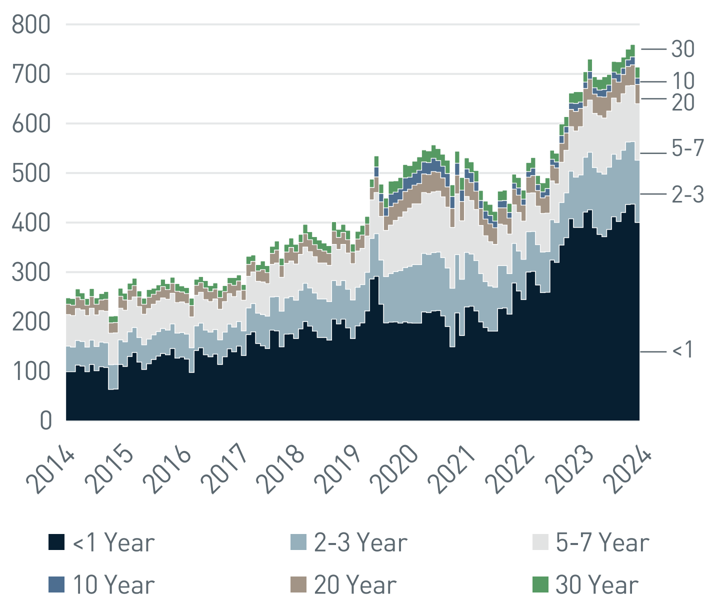
As we enter the new year, we expect the term premium, or the theoretical value of owning longer-duration fixed income securities, to improve. While the term premium averaged 48 bps from 2009-2019, much of the post-pandemic fixed income environment has been characterized by negative term premiums. From March 23, 2020, through December 31, 2024, the average term premium was -50 bps, implying little value in holding longer-duration securities. However, Fed cuts and the steepening yield curve have led to positive term premiums since early October. Further rate cuts should also make cash allocations less attractive. For additional insight, please see our commentary Is Cash Burning a Hole in Your Pocket - or Worse, in your Portfolio.

Looking ahead to 2025, it's also important to note the potential influence of outsized federal deficit and U.S. government debt levels on the UST market. Widening fiscal debt levels have coincided with a notable shift in the Treasury's own portfolio duration as the Treasury increased issuance following the pandemic (**Figure 14**).

Figure 14. U.S. Treasury Issuance by Maturity ($ billions)

The U.S. Treasury has shifted its portfolio toward low-duration issuance



As of 12/31/2024. Source: Bloomberg L.P.

The Treasury's shift toward shorter-term debt maturities may be altering the UST investor base, as some may not want to continuously reinvest in T-bills. The increase in short-term issuance is adding to UST market volatility; the ICE BofAML MOVE Index, a proxy for interest rate volatility, remains moderately higher than its 20-year average, as investors adjust to this new environment for USTs.

From a technical perspective, UST yields have remained challenged since the 10-year crossed above its 200-day monthly moving average in 2022. In May 2024, the 50-month moving average crossed above the 200-month average (a so-called, "golden cross" for technical analysis) and has remained in that upward trend ever since. In our view, upward technical momentum indicates investors' expectations for fixed income performance in 2025 to be largely driven by yields and income generation.

Corporate bonds

We expect a continued favorable environment for investment grade (IG) corporate credit in 2025. Balance sheet fundamentals remain healthy, and metrics such as interest coverage ratios sit near their long-term averages, despite elevated interest rates. As the business cycle strengthens, we believe we could see the credit cycle improve as companies are potentially upgraded over the course of 2025.

Credit spreads remain tight and are back to levels similar to early 2022 when the Fed was just beginning to raise interest rates. As such, we believe credit spreads should remain relatively tight as monetary policy continues to loosen. However, because valuations are relative, IG credit spreads could fall further from current levels. We saw this scenario in the 2000s when IG spreads were at or near their all-time lows and yet the asset class delivered positive total returns in 2004, 2005 and 2006.

Securitized bonds

Securitized bonds appear well positioned in the current market environment, as the asset class benefits from significant Fed-induced liquidity support. In fact, the Fed's balance sheet includes more than $2 trillion of mortgage-backed securities (MBS) — more than 14% of the MBS market.

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In addition to Fed liquidity, the MBS market is also benefiting from the current U.S. housing backdrop characterized by low inventory, rising prices and relatively high mortgage rates. As a result of the Fed's involvement in the MBS market, spreads remain low on an absolute basis at just 39 bps for the Bloomberg U.S. MBS Index. However, for perspective, spreads would need to compress by 80% to fall back to the lows of the cycle in 2021. With average 30-year mortgage rates around 7%, the Index yield of 5.1% remains attractive for core fixed income allocations.

The commercial mortgage-backed security (CMBS) market, which is about 20% of the size of its MBS counterpart, finally saw its credit spreads fall below its 10-year average earlier this year; however, the sector remains challenged. At 83 bps, CMBS spreads remain the highest of any component of the securitized bond market. In our view, continued concerns about CMBS sub-industries, such as office real estate, are reflected in the 5.2% yield for the Bloomberg U.S. CMBS Index.

Spreads for the asset-backed securities (ABS) market, which includes a diverse group of cash-flow assets, such as credit card debt, auto loans and other unique securities, are below their 10-year average, indicating investor optimism about consumer debt levels. We believe that while consumer debt has grown from historic lows exiting the pandemic, debt burden ratios are still well below their long-term average, indicating the growth in consumer debt should be sustainable. Thus, the Bloomberg U.S. ABS Index yield of 4.7%, as of December 31, remains in line with other components of the IG securitized bond market.

High yield

Given our expectation for a mid-cycle reacceleration, we believe the fundamental outlook for high yield (HY) is strong. Like IG credit, HY fundamental metrics, such as interest coverage, are near their long-term averages and supported by expectations for improving earnings growth.

While 2024 earnings were disappointing to some, the results were strong enough to help bolster credit fundamentals. Again, like IG credit, HY credit spreads have fallen to business cycle lows. In our view, HY spreads can be a useful coincidental indicator in the later innings of a cycle.

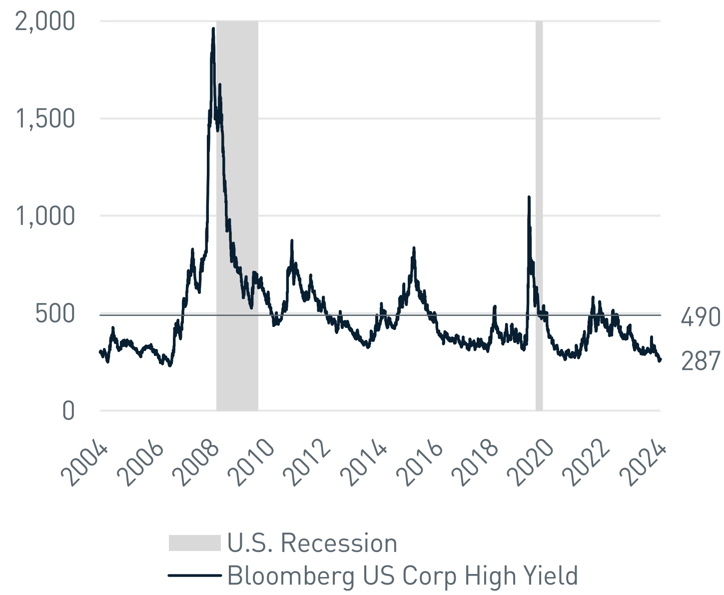
> Despite historically tight spreads, we still favor including an allocation to high yield in multi-asset portfolios."

For example, HY spreads bottomed in 2007 ahead of the global financial crisis, in 2014 before the earnings recession (during which the United States barely escaped a technical recession) and then again in January 2020 (**Figure 15**).

In the current cycle, HY spreads first bottomed in 2021 before rebounding slightly but have been hitting new lows since the Fed began cutting interest rates in September 2024. Despite historically tight spreads, we still favor including an allocation to HY in multi-asset portfolios given our positive outlook for financial markets. We believe credit spreads could fall further due to easing financial conditions and/or improving corporate balance sheets.

Figure 15. High Yield Option-adjusted Spreads (bps)

Credit spreads should not be used as a business cycle indicator, in our view



As of 12/31/2024. Source: Bloomberg L.P.

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Emerging market debt

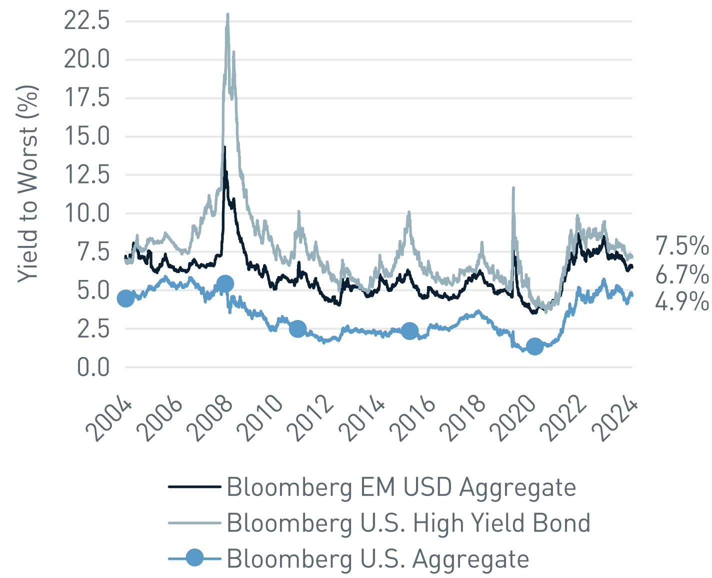
We believe dollar-denominated EM debt is attractive at current valuations given its potential for competitive risk-adjusted returns. The asset class offers higher yields and lower credit risk on a relative basis, due to its high proportion of sovereign issuance and the region's strong economic outlook in 2025. Consensus expects EM economies to grow real GDP by 4.2% in 2025 versus 1.8% for developed markets.

EM credit spreads have been tightening, we believe as a reflection of loosening monetary policy across most EM central banks (notable exceptions include Brazil, Indonesia and Turkey, which collectively make up more than 15% of the MSCI EM USD Aggregate Index). Additionally, we believe tighter spreads indicate investors are assigning a lower probability to risks from the potential spillover of geopolitical concerns into financial markets. The last significant widening in EM credit spreads was near the start of the Russia-Ukraine war, when spreads spiked above 400 bps. EM credit spreads similarly rose 440 bps during the pandemic-related global financial market selloff in February – March 2020. Based on our analysis, EM equity volatility is typically more sensitive to geopolitical headlines.

From a valuation standpoint, the yield-to-worst on the Bloomberg EM USD Aggregate Index (EMD Index) as of December 31 was 6.7%, with an option-adjusted spread of 220 bps (**Figure 16**). In contrast to HY, the spread of the EMD Index is still nearly 100 bps from its all-time low in 2007. With an outlook for positive global economic growth, especially among commodity-exporting countries that compose much of the EM debt market, we believe valuations for EM debt remain attractive.

Figure 16. EM Debt vs. U.S. Yields

EM debt yields remain attractive in a world of tight credit spreads



As of 12/31/2024. Source: Bloomberg L.P.

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Municipal bonds

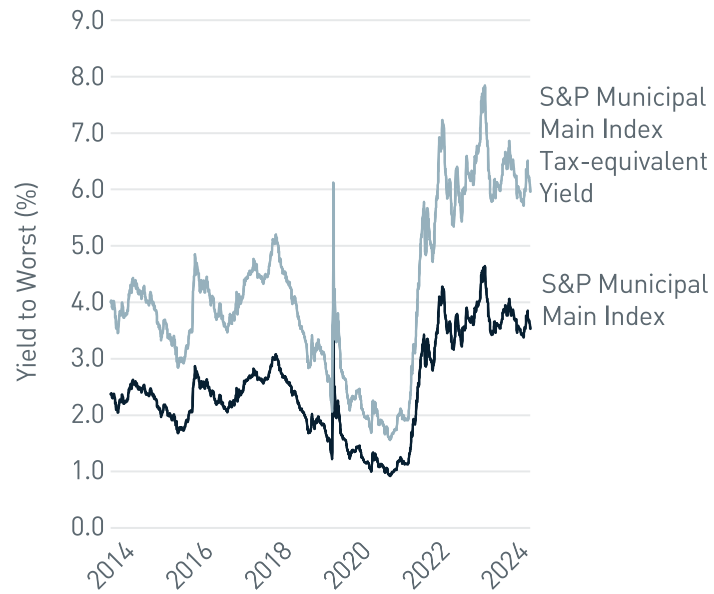
Through December 31, the S&P Municipal Bond Index generated a 1.90% total return as coupon income more than offset the impact of lower prices amid rising interest rates. On a tax-equivalent basis, tax-exempt municipal returns ranked highly compared to other fixed income asset classes for tax-sensitive investors (**Figure 17**). The environment allowed for positive returns, while supply-side technicals gave way to slightly higher absolute and relative rates as a starting point for the new year.

Entering 2025, we believe valuations reflect current fundamental conditions and the expectation for economic activity to remain supportive of municipal finances. While spread compression will always act as a return enhancer for municipal bondholders, historically tight credit spreads leave little margin for any deterioration from the current fundamental baseline. In our view, the year ahead will likely bring flat to potentially widening credit pricing, with income being the primary driver of returns. Improved relative valuations and higher absolute yields offer an attractive entry point for tax-sensitive investors, with the municipal index yield in the 83rd percentile of its 10-year range.

On the horizon in 2025 and beyond is the potential for regulatory changes that could alter the current tax shelter offered by most municipal bonds. The last time the tax shelter faced substantive changes was via the Tax Cut and Jobs Act of 2017. Investors should be prepared for additional modifications to current rules as prominent provisions of the Act expire in December 2025.

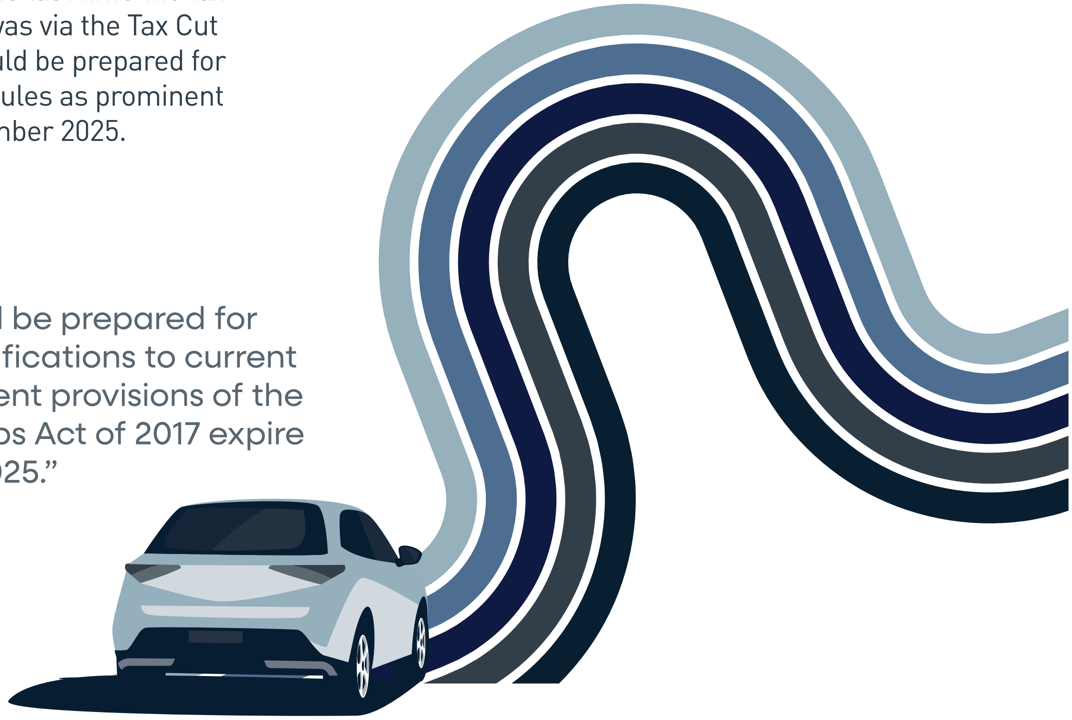
Figure 17. Municipal Tax-equivalent Yield

Tax-equivalent yields look attractive for tax-sensitive investors



As of 12/31/2024. Source: Bloomberg L.P., Standard & Poors
Tax-equivalent yield adjusts the municipal index's yield to worst to reflect the benefit of tax-exempt income using the highest federal marginal tax rate, plus the net investment income tax, equating to 40.8%.

> "Investors should be prepared for additional modifications to current rules as prominent provisions of the Tax Cut and Jobs Act of 2017 expire in December 2025."



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Alternatives: Green light

According to Preqin, private capital fundraising in 2024 slowed more than 24% compared to 2023 (**Figure 18**). We view this trend as a strong tailwind for 2025 as we expect a mid-cycle reacceleration to lead to renewed demand for alternatives. Deal activity slowed as consensus was expecting a mid-cycle slowdown — or even a mild recession in 2024 — that ultimately never occurred. As economic data strengthens, we expect deal flow to resume in 2025.

Private equity and private real estate fundraising fell 25% and 31% in 2024, respectively, as a lack of exit opportunities has caused older vintage-year funds to extend their holding periods, effectively keeping investor capital tied up and unavailable for new fundraising efforts. Private debt fundraising has slowed more modestly, declining 23%, as higher interest rates and constrained traditional lending markets have created opportunities.

So, where does that leave alternative investments in 2025? We believe a properly diversified alternatives portfolio should incorporate multiple vintage years and strategies. As such, it takes time to build an alternatives portfolio, and assessing performance is unique to the dynamics of each vintage year.

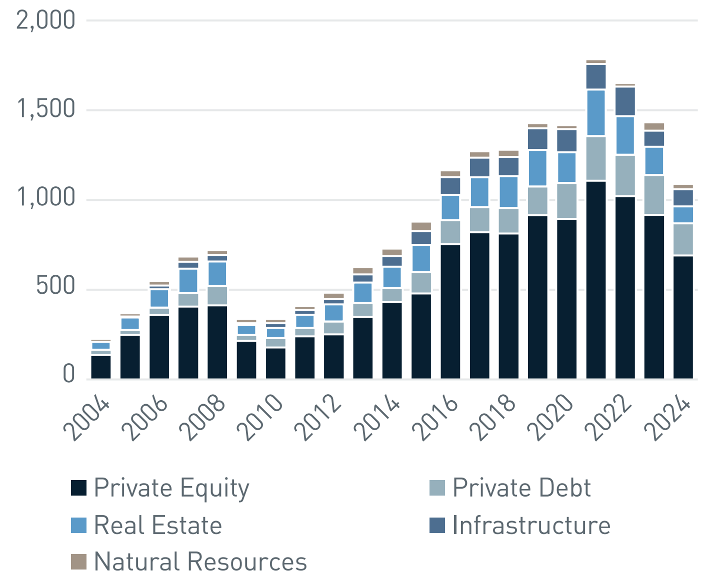
There are a few key private market trends taking shape in the alternatives landscape that support the critical role these investments can play in helping investors meet their longer-term goals including:

- the potential for an uptick in capital markets activity as the business cycle outlook improves;
- growth in AI adoption and use cases, leading to venture capital opportunities across a variety of sectors and industries; and
- opportunities for hedge funds to capitalize on uneven global economic business cycles and widening deficit spending.

Note, these views are specific to vintage year 2025.

Figure 18. Private Investments Capital Fundraising (billions $)

Slowing fund flows in 2024 are a sign of a healthy alternatives market heading into 2025



As of 12/31/2024. Source: Preqin

Private equity

Private equity valuations continue to face pressure from higher interest rates. Despite the Fed's initial rate cuts, interest rates remain well above prior levels that had kept financing costs low for private equity funds. We believe private equity will be challenged by elevated rates, causing lower asset valuations, as well as less favorable market conditions for initial public offerings (IPOs) and mergers and acquisitions (M&A).

Prior to the beginning of the Fed's most recent tightening cycle in 2022, historically low interest rates and pandemic-related stimulus contributed to a steady inflow of assets to private equity funds. However, activity dropped significantly in 2024, highlighted by moderating global M&A volumes (**Figure 19, page 19**).

A looser regulatory backdrop could potentially provide a pickup in M&A activity and IPO markets in 2025, but we do not expect it to occur immediately.

While some fund investors can weather delayed distributions, investor liquidity needs may create further opportunities in the secondary market, allowing long-term investors to purchase fund interest at an attractive discount.

Additionally, we expect opportunities in venture capital and growth equity markets to continue in 2025 as innovation from technological advancements in artificial intelligence and biotechnology research and development remains in the early innings. Given fund performance in those markets can vary considerably, we prefer investors allocate to fund-of-funds rather than single-manager funds, in contrast to our preference for traditional individual buyout funds.

Private debt

While the size of the private debt market remains small relative to traditional loans, private debt as a proportion of the lending market has grown substantially (**Figure 20**). Private debt typically comprises below-investment-grade direct lending, mezzanine, distressed or special situation debt.

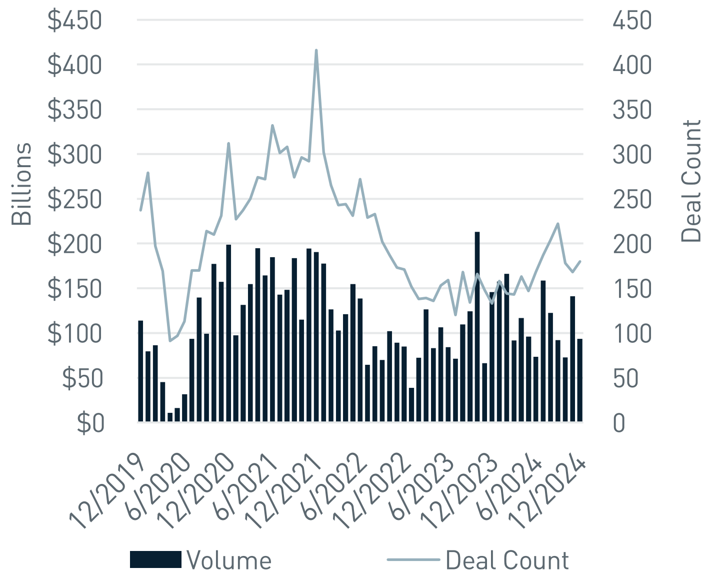
As lending standards among many traditional lenders remain tight, private debt has had the opportunity to fill the void. We believe the demand for alternative lending sources will continue in 2025, creating strong bargaining power for private debt funds to gain favorable terms. Additionally, the floating rate structure of private debt should provide a hedge against a potential reacceleration in inflation. With these tailwinds, we believe direct lending will be attractive for vintage year 2025.

We also believe the high-volatility financial market backdrop should be supportive of private debt. In volatile environments, private debt may offer relative stability, and returns that typically exceed those of traditional fixed income, while exhibiting a relatively low correlation to other asset classes.

Finally, we continue to see favorable reward-risk dynamics for private debt, due to the illiquidity premium for investing in smaller, unrated loans.

Figure 19. M&A Activity

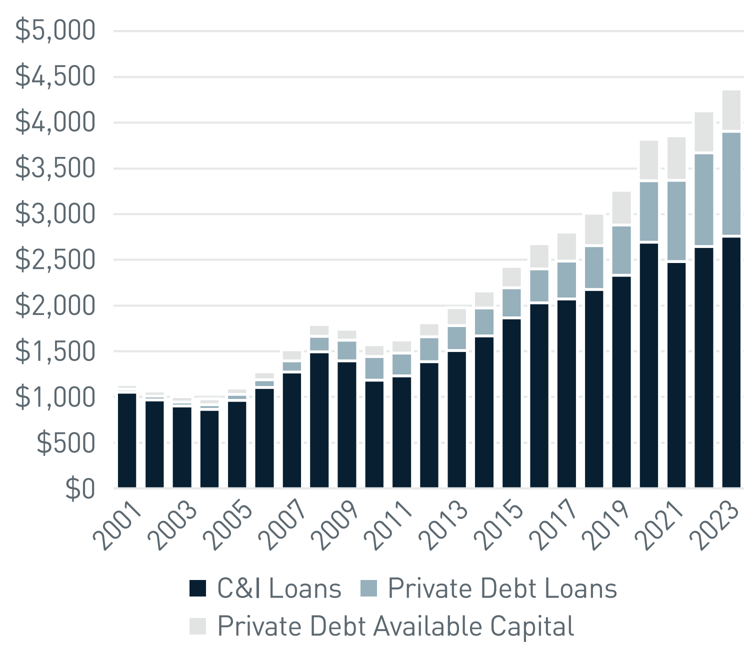
Fund flows slowed as capital markets activity slowed in 2024



As of 12/31/2024. Source: Preqin

Figure 20. Lending Growth via Traditional Lenders vs. Private Debt ($ billions)

Private credit demand continues to climb as investment opportunities persist



As of 12/31/2024. Source: Preqin

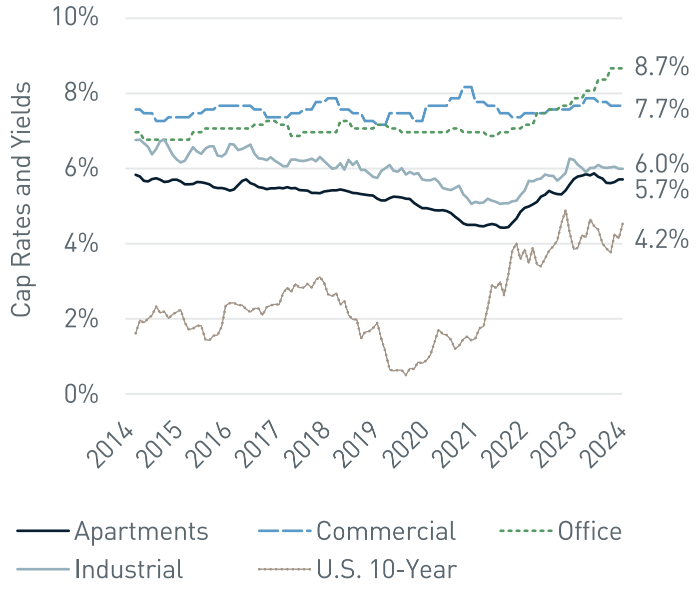
Private real estate

We believe the outlook for private real estate is far from uniform across the asset class. The office real estate sector continues to face structural challenges from remote work, while the specialty, residential and industrial sectors have benefited. Capitalization rates have remained elevated as tighter financial conditions have driven up borrowing, construction and operating costs, while USTs remain well above their levels of the past decade, leading to stretched valuations (**Figure 21**).

We anticipate a near-term shift in the real estate market in favor of buyers, as sellers look to reduce leverage and raise liquidity amid a wave of real estate loans that are slated to come due in 2025. As such, we believe there are several areas within the private real estate landscape that present attractive opportunities for managers. The residential rental sector remains attractive in our view, as high interest rates and housing shortages have kept many tenants in the rental market longer. Additionally, we believe real estate associated with data centers and the infrastructure needed to support AI continue to present worthwhile opportunities.

Figure 21. Real Estate Capitalization Rates vs. 10-Year U.S. Treasury

The hetergenous nature of real estate provides opportunities for investors



As of 12/31/2024. Source: Bloomberg L.P.

Hedge funds

Macroeconomic forces are set to bring both opportunities and challenges for investors seeking to diversify their sources of alpha in 2025. With credit spreads at all-time lows and equity markets at or near all-time highs, we believe the importance of diversification outside traditional asset classes is amplified.

Across all sub-categories of hedge funds, we are most constructive on global macro, equity and credit long-short, and managed futures strategies. We believe 2025 will bring increased focus on global fiscal and monetary policies, along with heightened geopolitical risks. Domestically, several key macro themes, including shifting supply chains, foreign trade changes and increased defense spending could create substantial opportunity for low-correlation investment strategies.

Given current intra-stock correlations for the S&P 500 (0.16 as of December 31) are well below their five-year average (0.33), we believe the market environment heading into 2025 is ripe for hedge funds to generate attractive risk-adjusted returns for both fundamental and systematic strategies. In addition, we expect the ability of hedge funds to quickly calibrate risk exposures will be beneficial in an environment characterized by rapidly changing macroeconomic and geopolitical influences.

What a long, strange trip it's been!

After two years of strong financial market returns, we are still generally positive about the prospects for 2025. As valuations return near 2021 levels, easing financial conditions make the comparison with long-term averages less helpful of a guide for the path forward. Fiscal and monetary policy are expected to be the driving forces of macroeconomics, with inflation being one of the primary variables. As such, we continue to favor diversified, multi-asset portfolios to capture potential market crosscurrents.

Our investment process will be our most reliable source for navigation in 2025, helping us drive toward certain asset classes and steer away from others. Even last year's 25% return for the S&P 500 included an 8.5% drawdown, so investors should never put risk management into cruise control. No matter your choice of vehicle on your investment journey, the most important part is reaching your final destination — your long-run investment goals and objectives.

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Amanda Agati, CFA
Chief Investment Officer

Daniel J. Brady
Managing Director, Investment Strategy

Yasin Bentiss, CFA
Director, Investment Strategy

Bethany A. Stein, CFA
Director, Investment Strategy

Rebekah M. McCahan
Senior Investment & Portfolio Strategist

Ian Bell, CFA
Investment & Portfolio Strategist

Arpit Shah
Investment & Portfolio Strategist

Adam Mackey
Managing Director, PNC Fixed Income

William Bonawitz, CFA
Director of Credit Research

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