

Patten & Patten, Inc.

1Q25 Market Outlook

January 2, 2025



Market Outlook

Market Commentary *December 31, 2024*

In 2024, we disagreed with consensus forecasts regarding Fed policy, interest rates, inflation, and the bond market outlook. For example, we felt Wall Street strategists were excessively optimistic with respect to the number of rate cuts. Our stance informed strategy in that context as we felt longer maturity bonds offered insufficient yields, an outlook we have maintained since 2022. For the past three years, the average annual return of money market funds has exceeded the benchmark bond index by a wide margin. In fact, the bond index's three-year annualized return is negative. The best performing bonds have been those with the shortest maturities, consistent with our outlook.

The monetary cycle reversed in 2024 as the Fed began to cut rates in a process they called “recalibration.” The Fed justified the shift in policy because, when compared with theoretical guideposts, policy had become too restrictive. Thus, they sought to avoid a policy error – i.e., leave rates too high and impede an already slowing economy.

Therein lies the risk for 2025 and beyond. In our view, the Fed cut rates prematurely and risks a different policy error – i.e., reduce the policy rate unnecessarily and stoke resurgent inflation.

We note that, for the first time in history, the yield on the 10-year Treasury rose 1.00% as the Fed cut policy rates 1.00%. This is anomalous market behavior that should prove unsustainable long-term. Nevertheless, as a market signal, it recommends vigilance toward inflation.

The shift in interest rates restored a positive slope to the Treasury yield curve, which both removes distortions and facilitates traditional fixed income strategies. The positive slope also improves margins for the banking sector. However, higher market yields increase the cost of capital for borrowers, which could reduce both economic activity and equity valuations.

To the extent inflation proves recalcitrant, the Fed might confront a future dilemma regarding the direction of policy. The Fed would have two choices. They could disregard theoretical guideposts and raise policy rates, demonstrating respect for market signals regarding growth and inflation. On the other hand, the Fed could follow theory and reduce rates further, risking an inflation surge. It is certain that the stock and bond markets would not welcome a shift back to restrictive Fed policy. In this manner, the Fed's commentary and policy actions in the New Year could trigger market volatility.

Market Commentary cont. – *December 31, 2024*

With regard to equities, US stocks outperformed International in 2024. Large caps outperformed small caps. A concentrated portfolio of the largest US stocks outperformed broad-market and equal-weighted indexes. These performance divergences were contrary to consensus expectations at the beginning of 2024. In our view, the performance divergences primarily reflect fundamentals. For this reason, it is possible that concentrated portfolios of large cap US equities remain market leaders for an extended period.

We are constructive for 2025 and agree with consensus that anticipated de-regulation should expand corporate margins and boost activity. However, we have long-term concerns that rolling back safeguards in certain industries, particularly financial services, could lay the groundwork for future instability.

Markets

Year to date and historical performance of select asset classes

		Annualized			Total Returns since...	
	YTD	1 year	3 Year	5 Year	10/30/2022	1/3/2022
Domestic Equities						
S&P 500	25.02	25.02	8.94	14.52	55.94	28.47
S&P 500 Equal Weight (RSP)	12.78	12.78	4.26	10.57	29.75	13.23
S&P 100	30.95	30.95	11.26	16.70	69.91	36.20
Dow Jones Ind. Avg.	14.99	14.99	7.56	10.55	35.34	23.59
NASDAQ Comp	29.57	29.57	8.13	17.48	77.05	24.94
Russell 2000 (IWM)	11.39	11.39	1.15	7.30	24.46	2.18
International Equities						
Shanghai Composite (CIN)	9.47	9.47	-7.01	0.95	14.28	-19.59
Hedged Japan (DXJ)	29.76	29.76	24.96	19.06	86.78	94.40
Hedged Europe (HEDJ)	5.28	5.28	6.27	7.45	37.06	18.31
Emerging Marlets (EEM)	6.50	6.50	-2.67	0.79	30.23	-8.44
Canada (EWC)	12.40	12.40	3.93	8.51	29.31	11.87
Bonds						
Long Treasuries (TLT)	-8.06	-8.06	-13.39	-6.04	-2.12	-33.28
Inv. Grade Corporates (LQD)	0.86	0.86	-3.25	-0.27	15.22	-8.47
High Yield Corporates (HYG)	7.97	7.97	2.34	3.04	20.52	7.23
Core US Aggregate Bond (AGG)	1.31	1.31	-2.36	-0.35	9.77	-6.27
US 1-3 Month T-bills (BIL)	5.19	5.19	3.82	2.34	11.14	11.93
Real Assets/Commodities						
Commodities (BCI)	5.46	5.46	3.48	6.28	-2.06	10.47
Gold (GLD)	26.66	26.66	12.30	11.12	58.09	43.84
Oil (BNO)	9.67	9.67	12.72	7.51	-2.35	41.54
Real Estate Investment Trusts (RMZ)	4.59	4.59	-6.09	0.43	13.00	-16.68
Agriculture (DBA)	33.47	33.47	13.77	11.92	48.26	47.89

YTD through 12/31/2024

Note: returns presented as %, assumes dividends are reinvested

Source: FactSet

Year to date and historical performance of select equity sectors

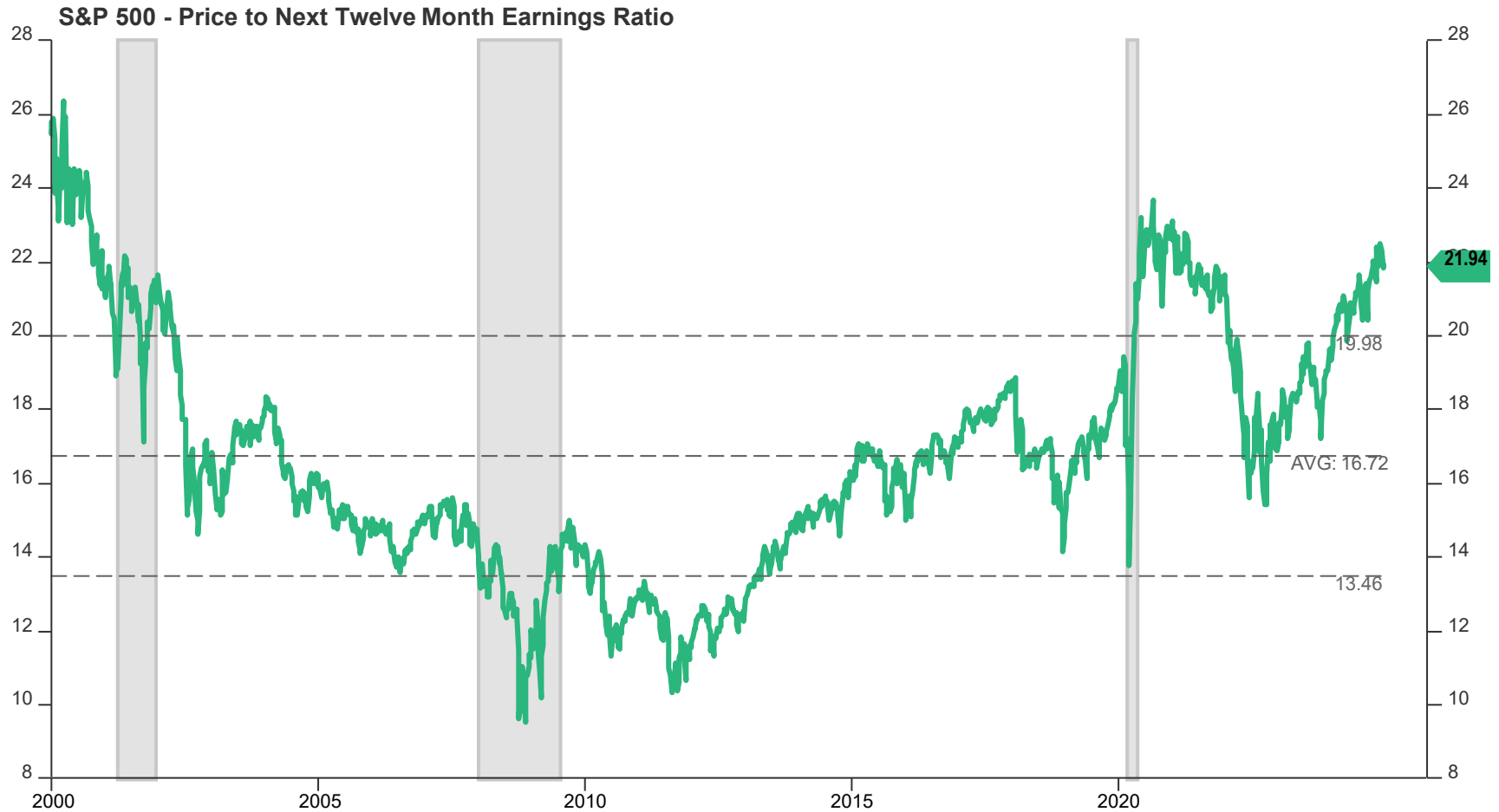
Domestic Equity Sectors, Tilts & Factors	YTD	Annualized			Total Returns since...	
		1 year	3 Year	5 Year	10/30/2022	1/3/2022
Sectors						
Consumer Discretionary	29.13	29.13	4.37	13.17	61.71	10.63
Retail (XRT)	11.78	11.78	-2.43	13.45	31.18	-8.44
Consumer Staples	11.98	11.98	1.99	5.70	12.03	6.10
Energy	2.31	2.31	15.70	7.48	-4.50	50.25
Oil & Gas Exploration	-1.03	-1.03	14.20	9.60	-6.04	42.19
Financial Services	28.43	28.43	7.36	9.48	41.62	22.23
Regional Banks (KRE)	18.57	18.57	-2.38	3.74	1.53	-8.66
Health Care	0.90	0.90	-0.80	6.19	3.68	-1.42
Industrials	15.64	15.64	7.62	10.16	39.38	25.69
Aerospace & Defense (XAR)	23.32	23.32	13.18	9.51	57.74	43.81
Transportation (IYT)	4.11	4.11	0.52	7.95	30.71	1.82
Materials	-1.83	-1.83	-2.39	6.54	12.65	-5.70
Homebuilders (XHB)	9.87	9.87	7.72	19.08	80.48	27.51
Technology	35.69	35.69	14.69	23.39	102.92	49.33
Communication Services	38.89	38.89	8.50	13.46	107.55	27.02
Utilities	19.58	19.58	1.91	3.23	12.43	6.84
Real Estate	1.73	1.73	-7.63	1.27	10.90	-20.43
Style Tilts						
Large Cap Growth (IWF)	33.12	33.12	10.30	18.77	81.57	33.24
Large Cap Value (IWD)	14.18	14.18	5.46	8.52	28.95	16.89
US High Dividend (HDV)	14.17	14.17	7.54	6.79	18.49	24.12
Factors						
Minimum Volatility (USMV)	15.75	15.75	4.98	8.11	29.12	16.41
Momentum (MTUM)	32.89	32.89	5.84	11.78	43.75	18.33
Quality (QUAL)	22.28	22.28	8.36	13.58	61.19	27.60

YTD through 12/31/2024

Note: returns presented as %, assumes dividends are reinvested

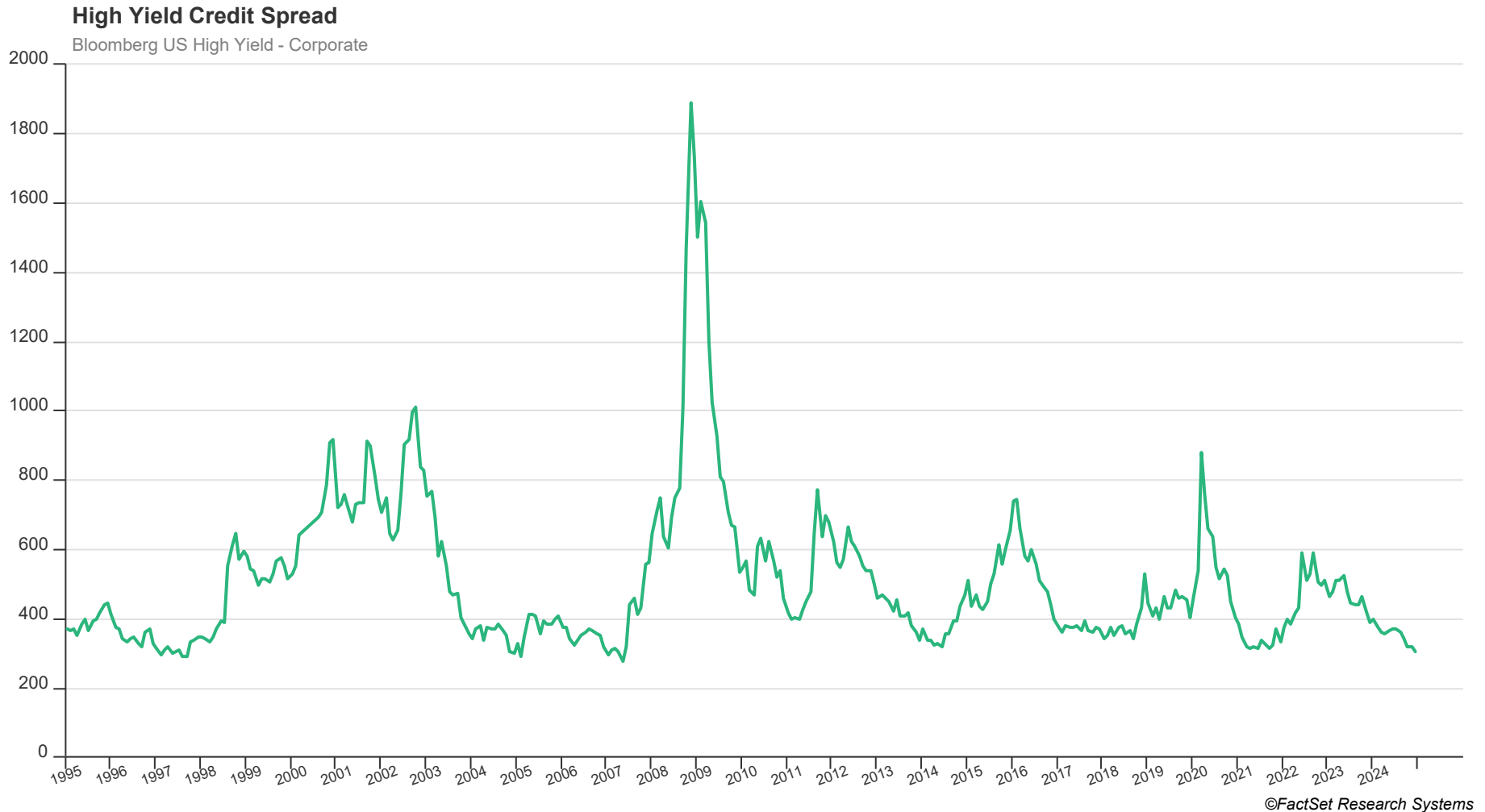
Source: FactSet

S&P 500 Valuation

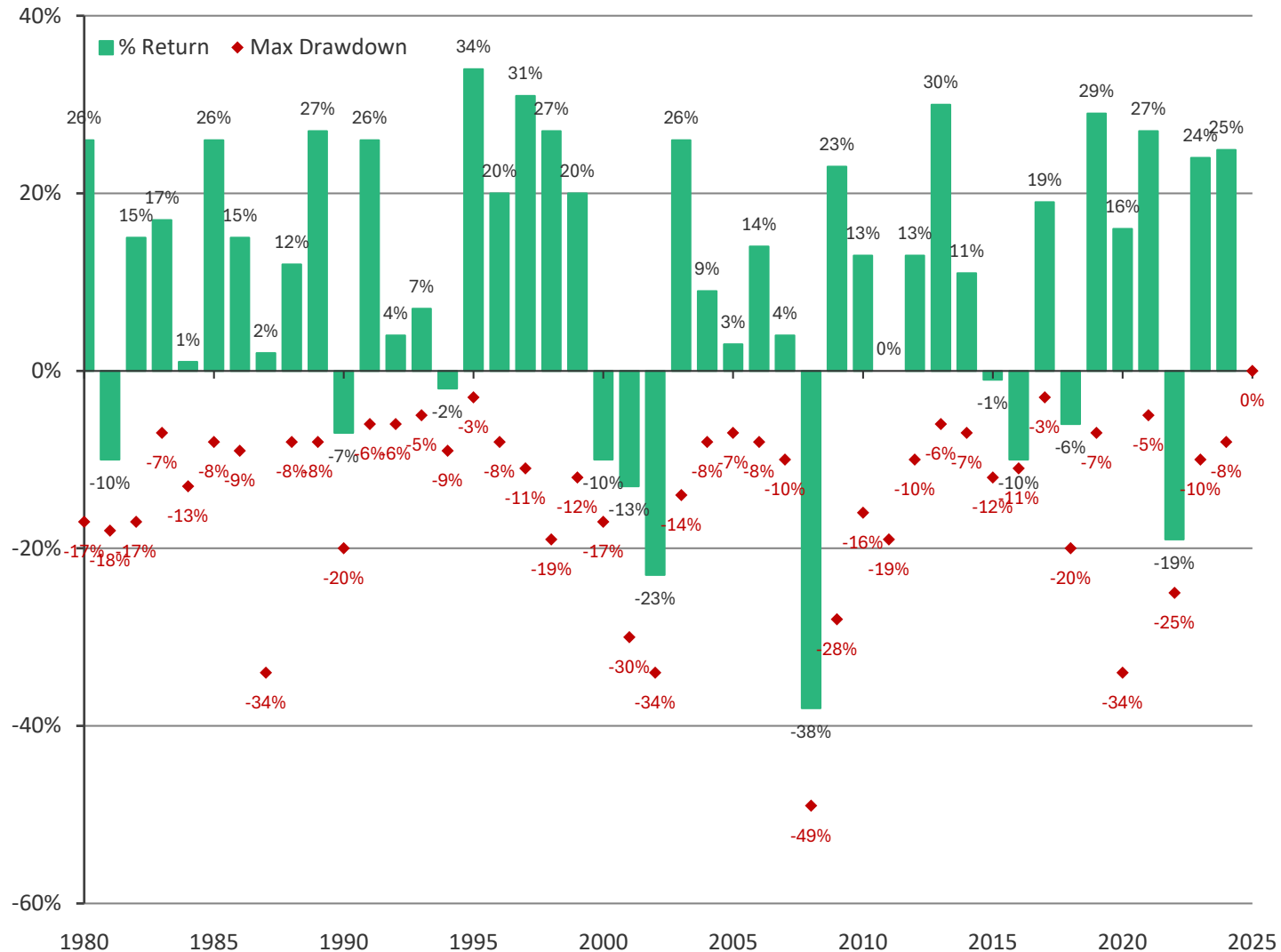


Source: FactSet Research Systems

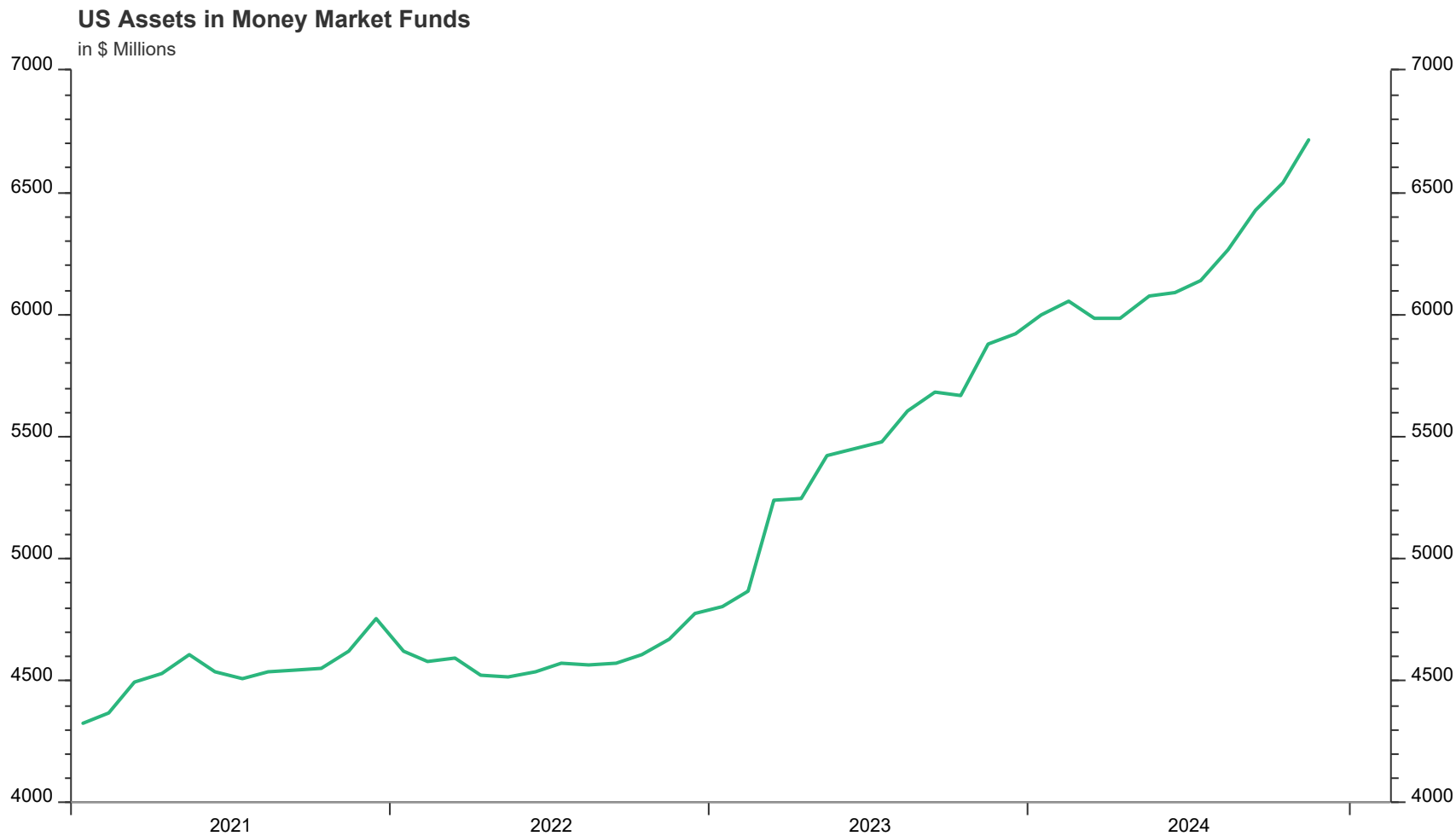
Credit Spreads



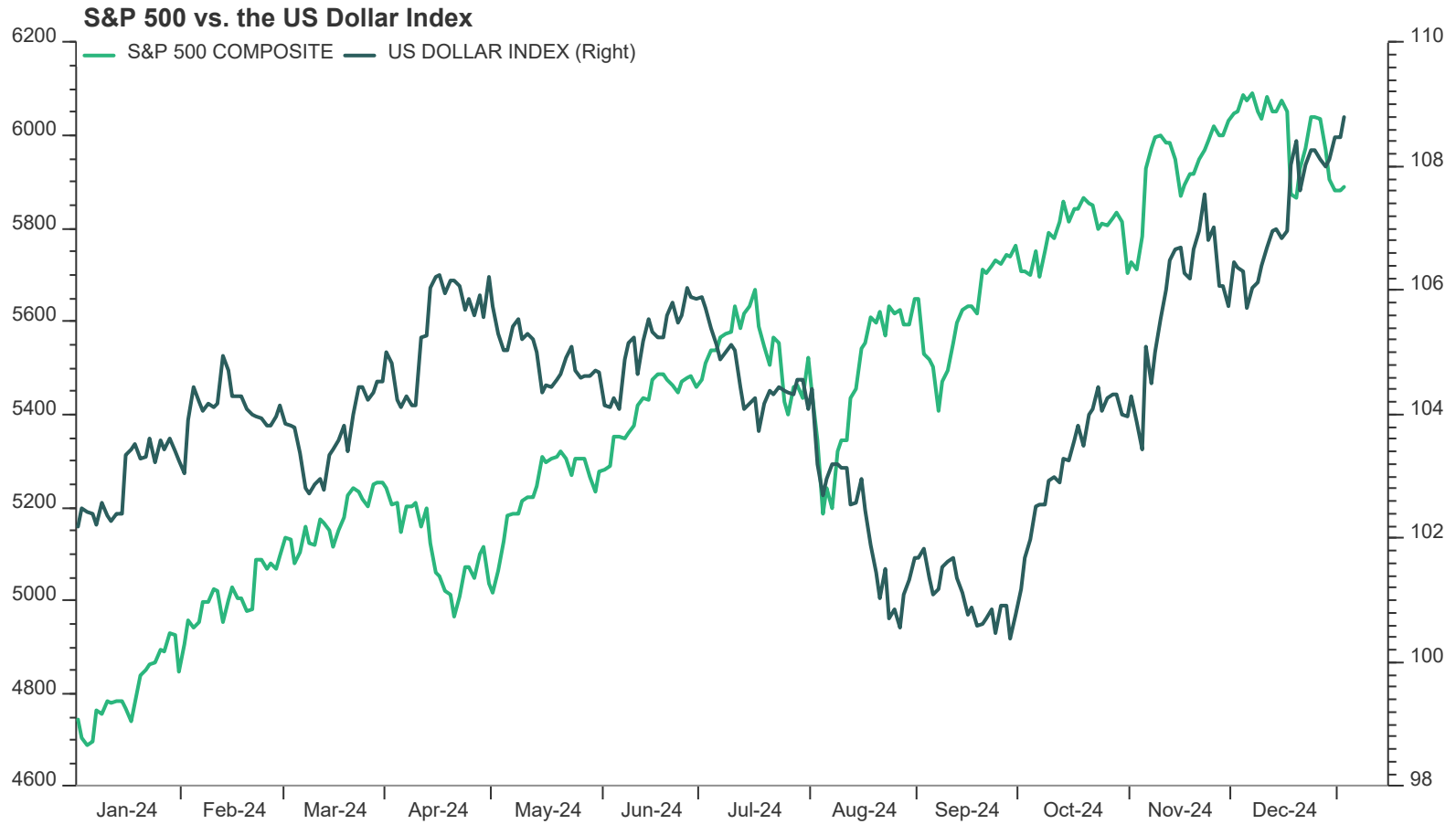
Stock Market Performance and Max Drawdowns by Year



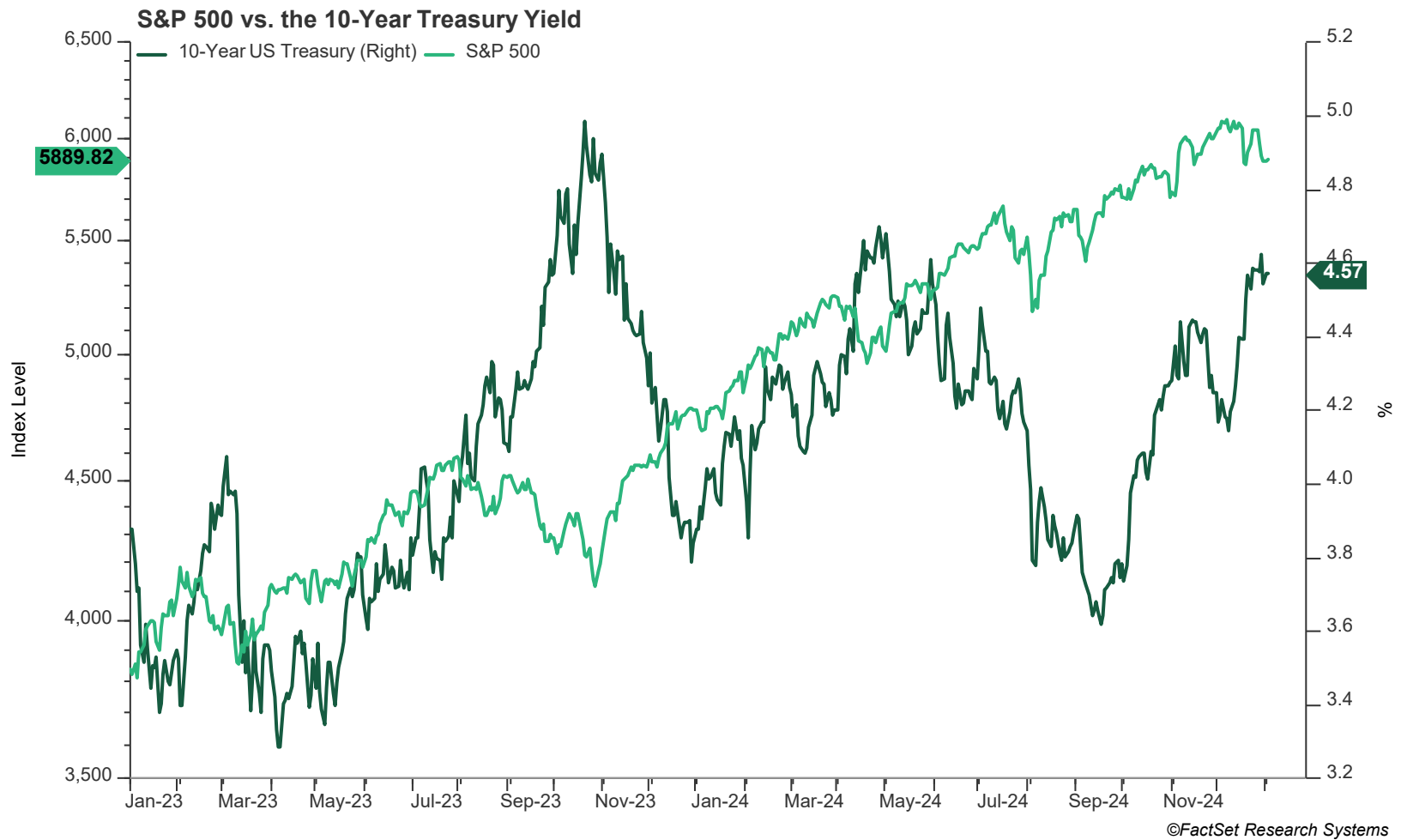
Flight to Cash



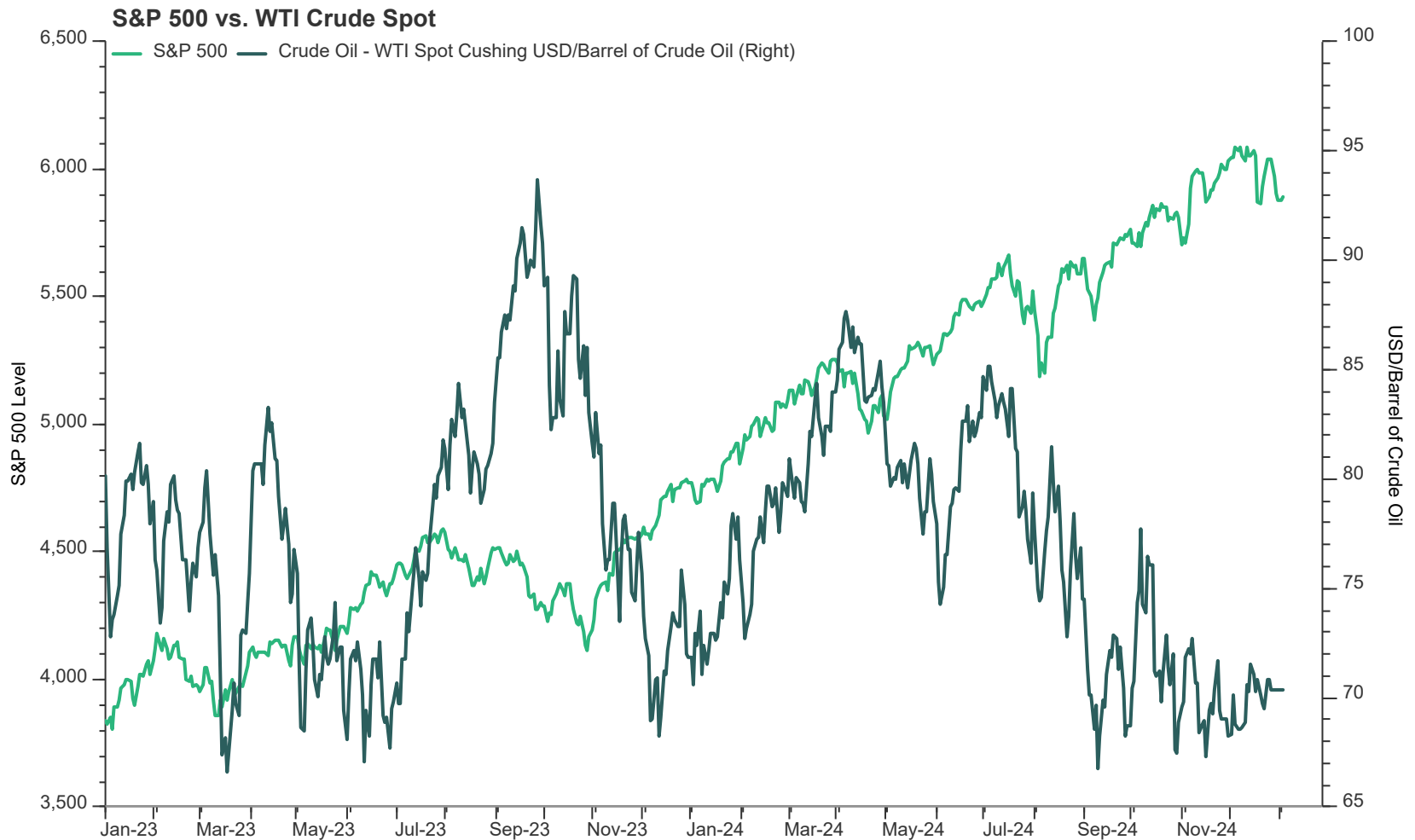
S&P 500 vs. the US Dollar Index



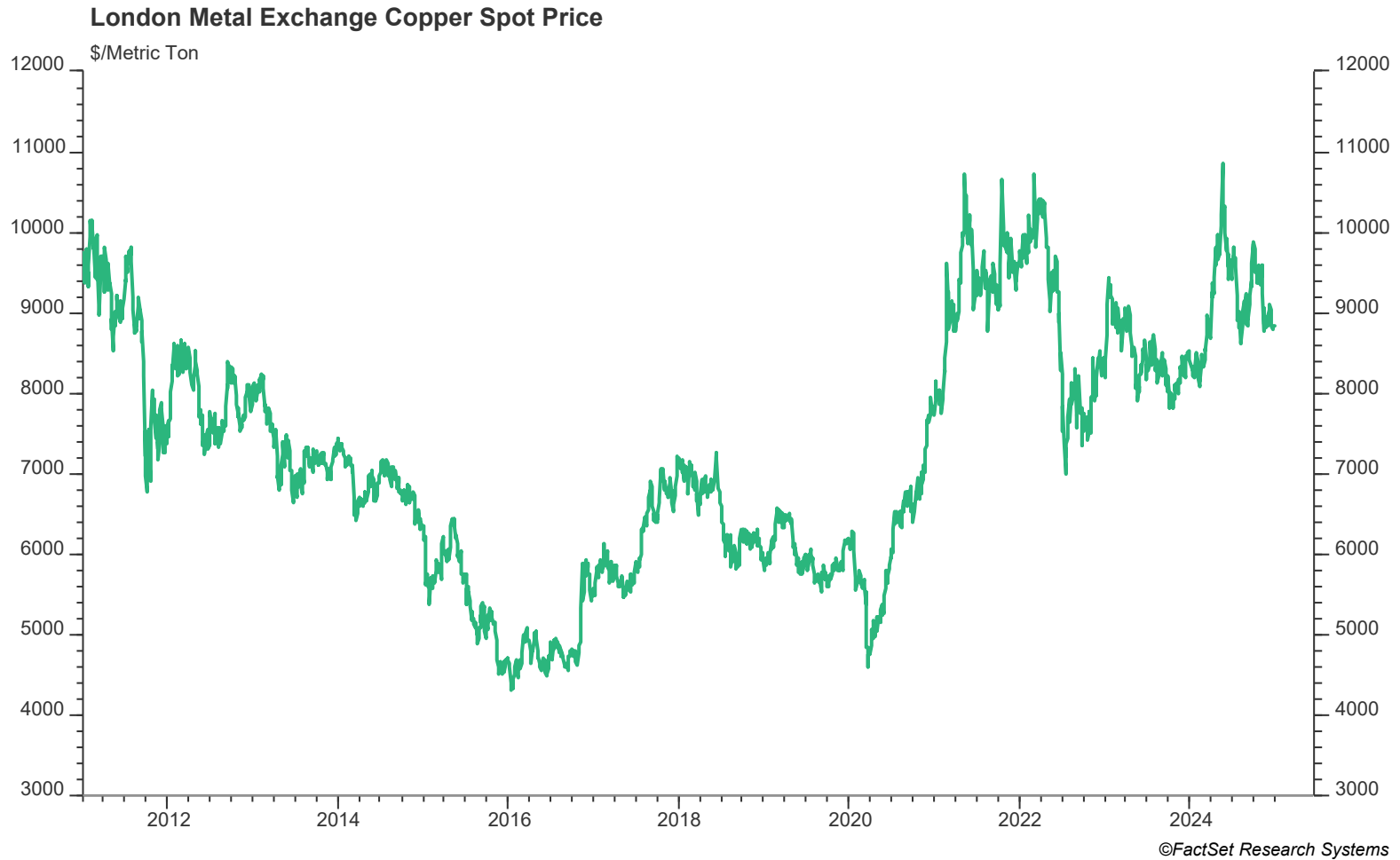
S&P 500 vs. the 10-Year Treasury Yield



S&P 500 vs. the Price of Crude Oil



Dr. Copper



Interest Rate Outlook

Global Interest Rates

Global Bond Yields on 12/31/2024

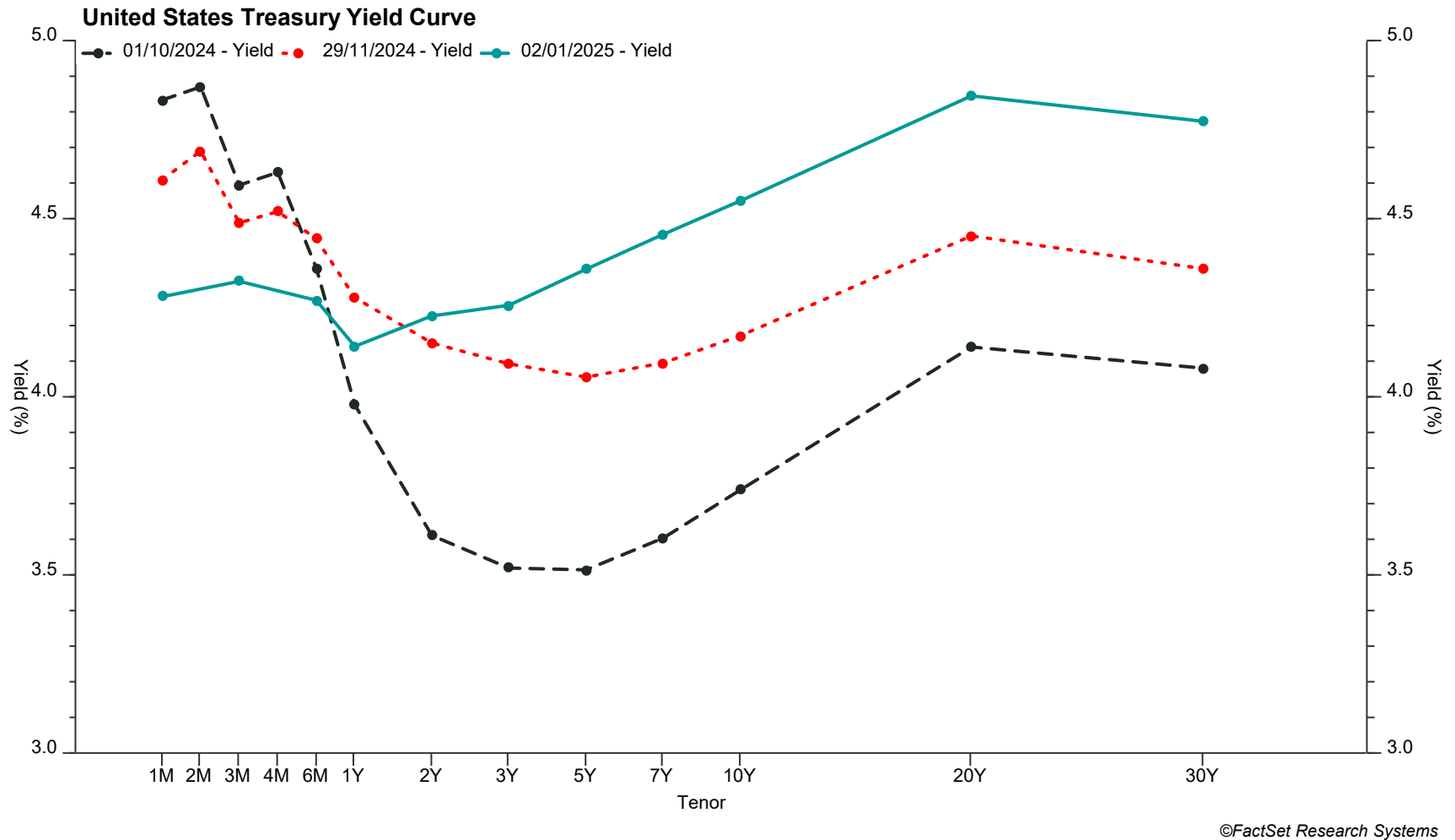
Maturity	US	Canada	UK	Germany	Switzerland	Japan	Spain	Italy	Brazil	Greece
2Y	4.243	2.936	4.366	2.078	0.079	0.598		2.450	16.092	
5Y	4.382	2.964	4.336	2.151	0.147	0.734		2.848	15.970	
10Y	4.572	3.226	4.563	2.354	0.313	1.089		3.514	15.391	
30Y	4.783	3.329	5.131	2.584	0.379	2.280		4.188		

Change in Global Bond Yields since 12/24/2024

Maturity	US	Canada	UK	Germany	Switzerland	Japan	Spain	Italy	Brazil	Greece
2Y	-0.098	-0.087	-0.009	0.033		0.014		-0.003	0.493	
5Y	-0.063	-0.084	-0.007	0.032	-0.001	0.009		0.008	0.828	
10Y	-0.013	-0.067	-0.004	0.037	0.041	0.022		0.021	0.810	
30Y	0.023	-0.043	-0.014	0.042	0.005	0.027		0.032		

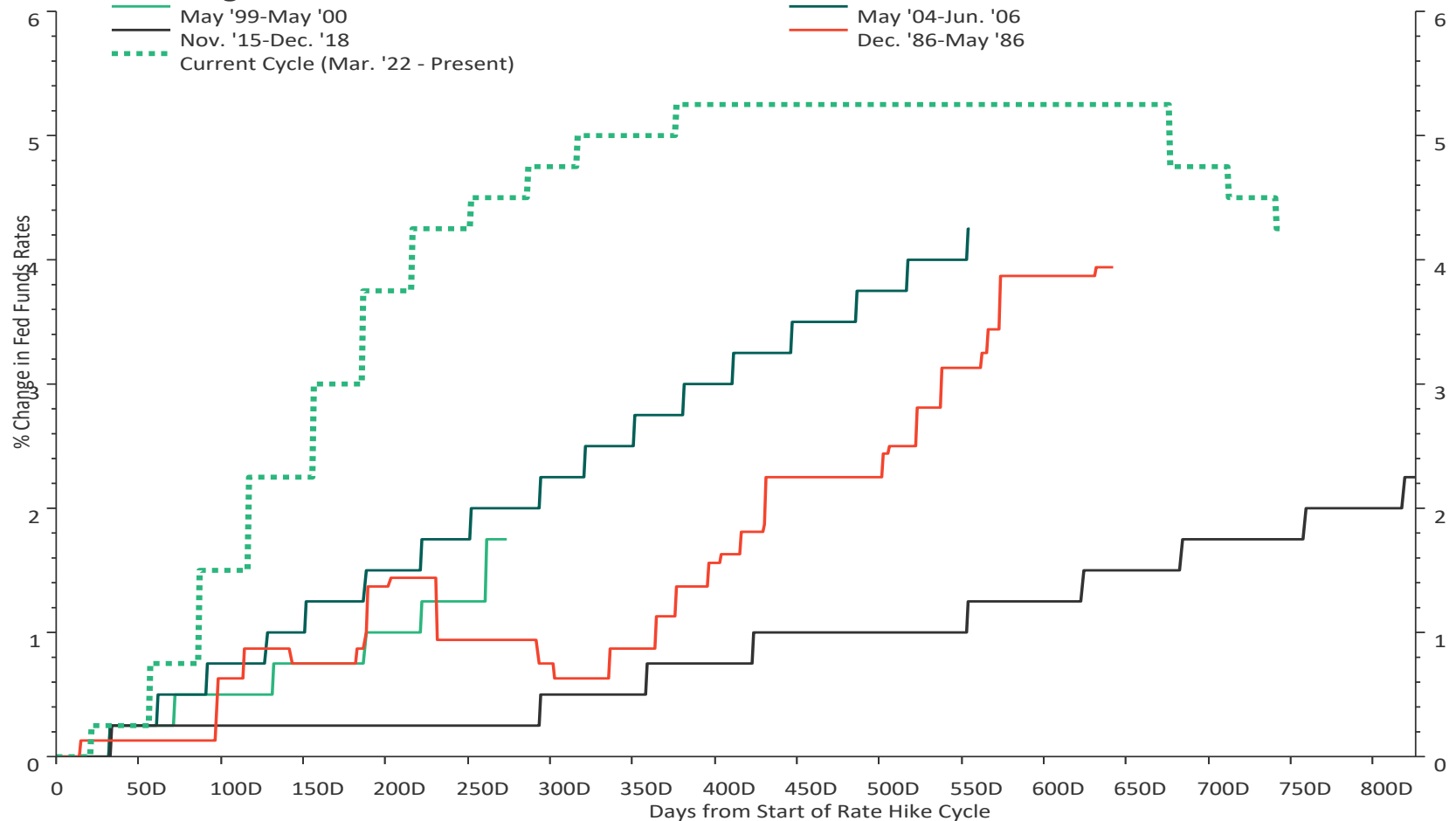
Source: FactSet

US Treasury Yield Curve



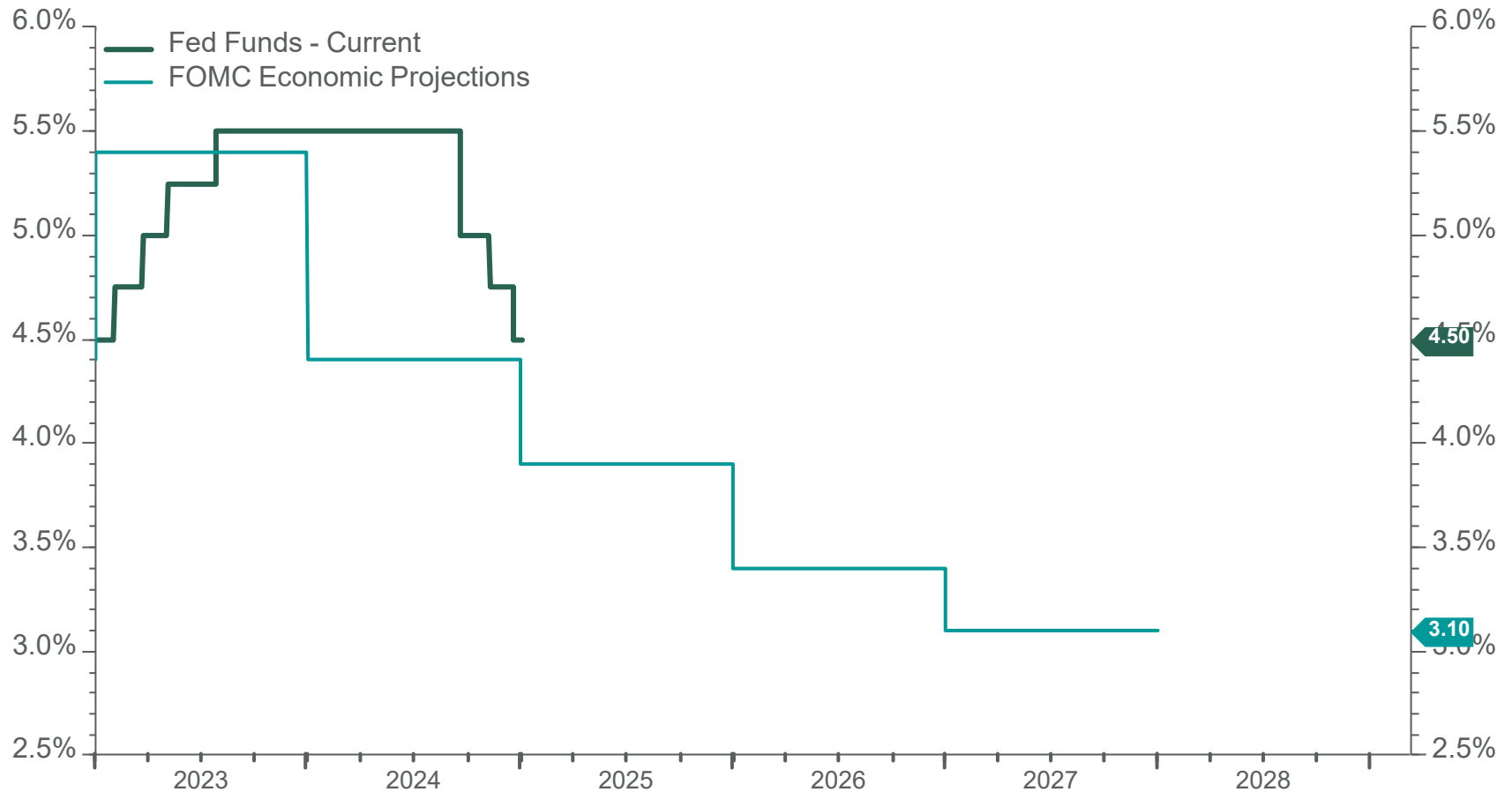
Historical Perspective of Current Fed Policy

Cumulative Change in Federal Funds Rate Since First Hike



Source: LSEG Datastream

US Federal Funds Target Rate: Current vs. Projected



Source: FactSet Research Systems

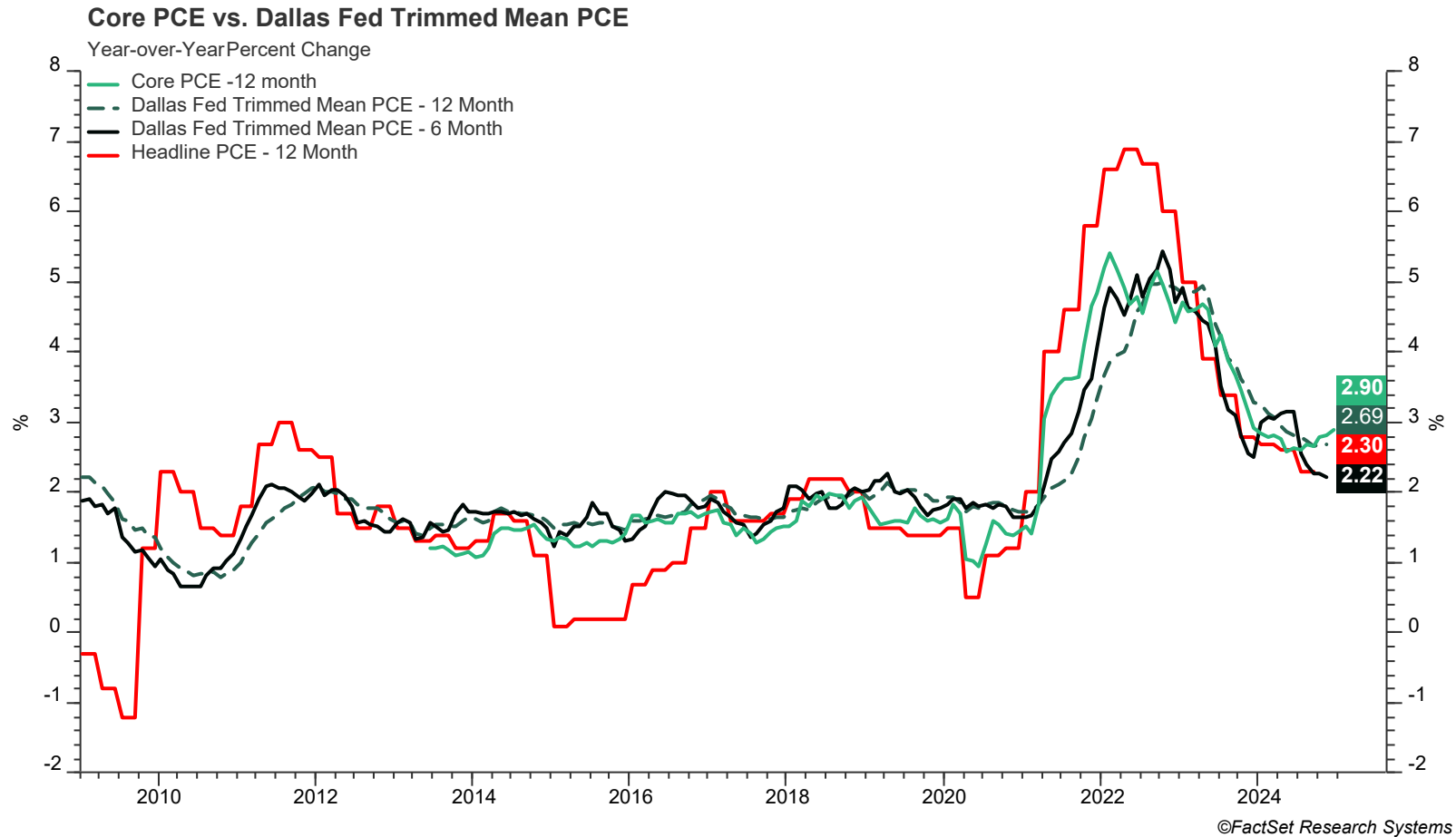
Fed Rate Hike Probability

Rate Probability by Meeting

Meeting Date	Mid-Point of Fed Funds Target Range: Current Market Expectations							
	2.625	2.875	3.125	3.375	3.625	3.875	4.125	4.375
1/29/2025							11.2%	88.8%
3/19/2025						5.4%	48.4%	46.2%
5/7/2025					1.4%	16.5%	47.9%	34.3%
6/18/2025				0.6%	7.4%	28.9%	42.5%	20.7%
7/30/2025			0.1%	1.7%	10.9%	31.2%	38.9%	17.3%
9/17/2025		0.0%	0.4%	3.4%	14.7%	32.6%	34.9%	14.1%
10/29/2025	0.0%	0.1%	0.7%	4.7%	16.7%	32.9%	32.5%	12.5%
12/10/2025	0.0%	0.1%	1.1%	5.9%	18.4%	32.8%	30.4%	11.2%

Source: FactSet

Inflation Measures

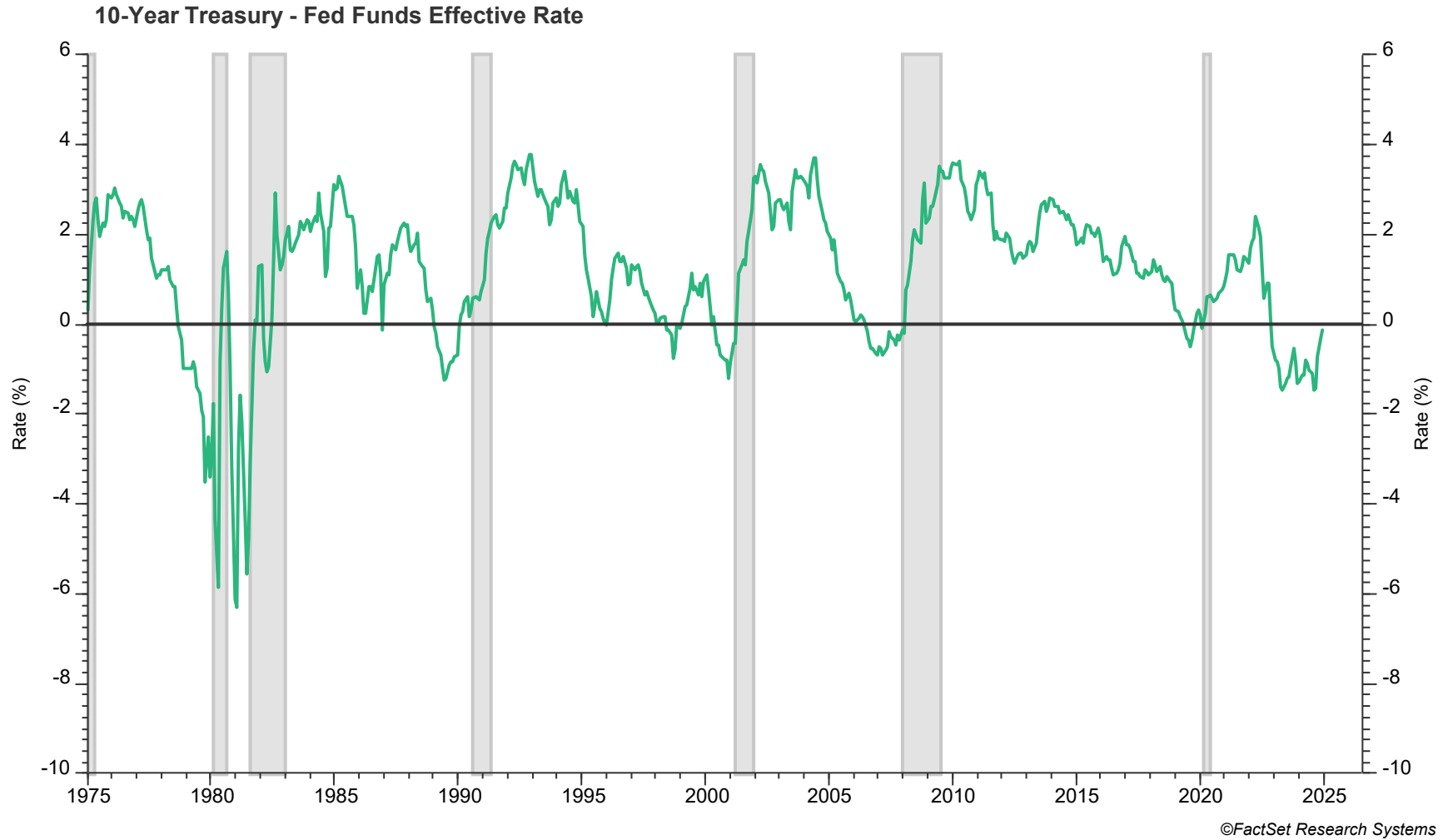


Treasury Yield Spread

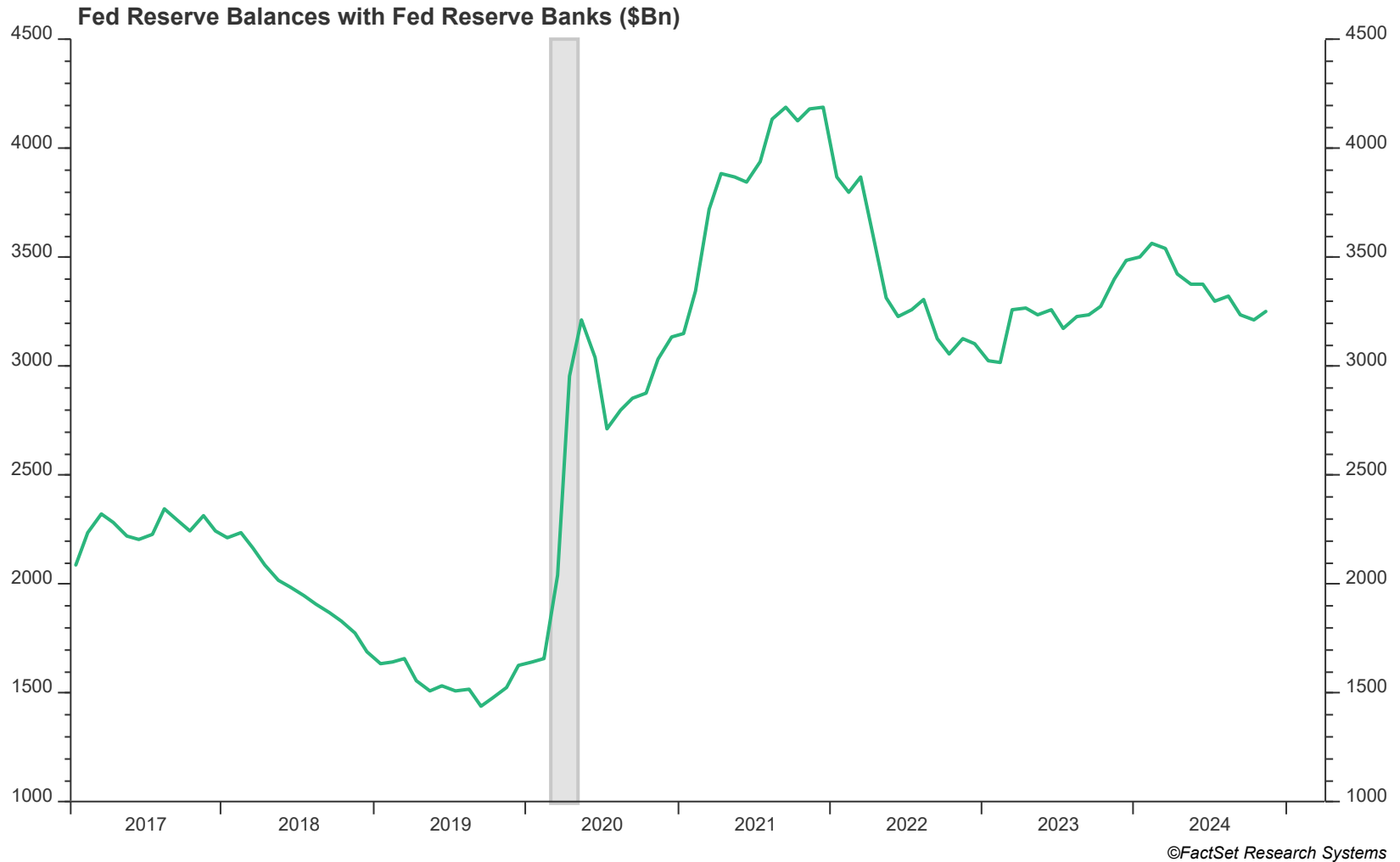


Yield Curve Inversion	Recession Lag	S&P 500 Peak Lag	S&P 500 Return to Peak post Yield Curve Inversion
Aug-78	17 months	19 months	17.70%
Sep-80	10 months	3 months	13.60%
Dec-88	19 months	20 months	35.70%
Feb-00	13 months	2 months	8.40%
Dec-05	24 months	23 months	23.50%
Aug-19	6 months	6 months	0.75%

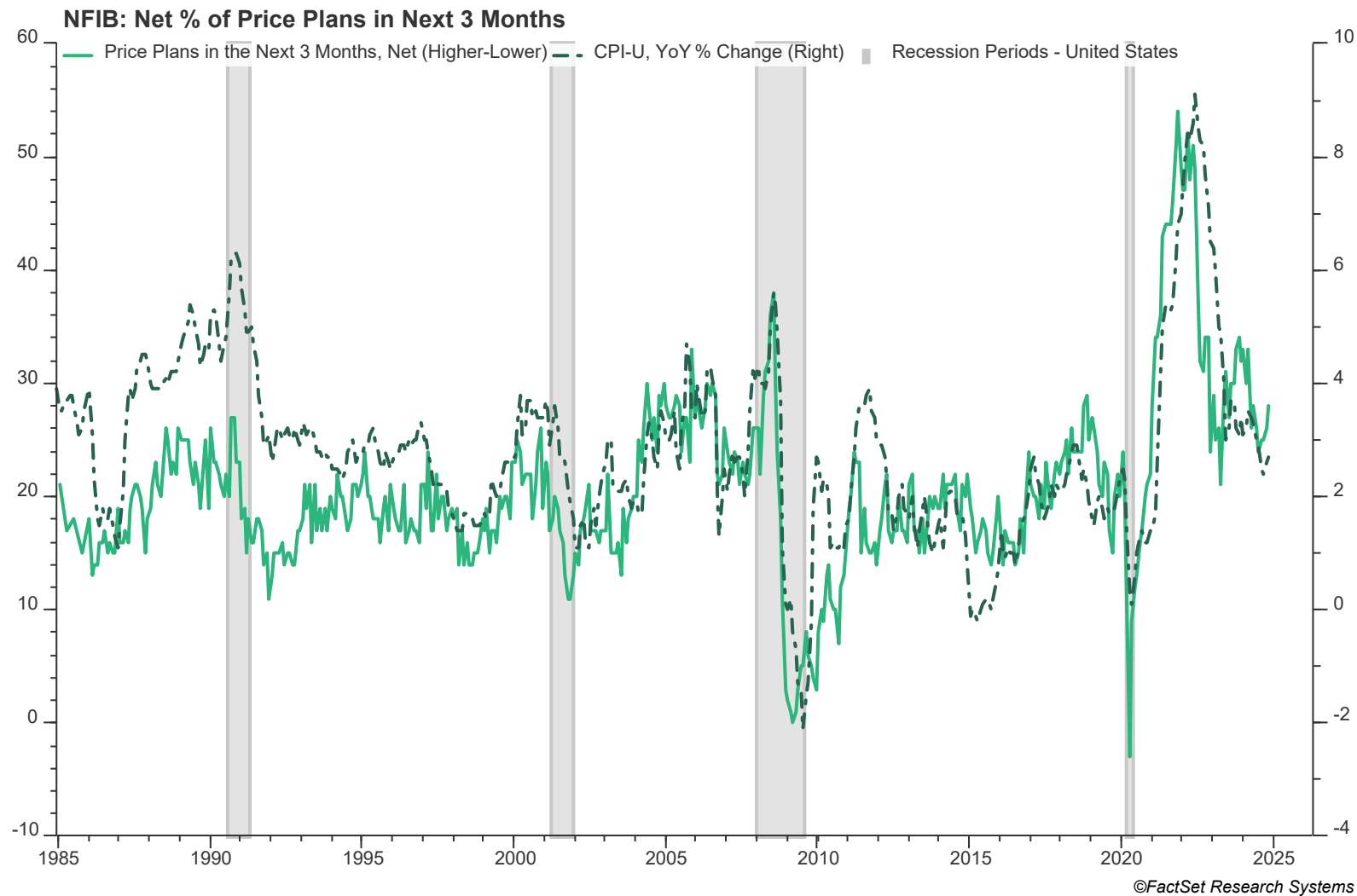
Interest Rate Spreads



Fed Balance Sheet

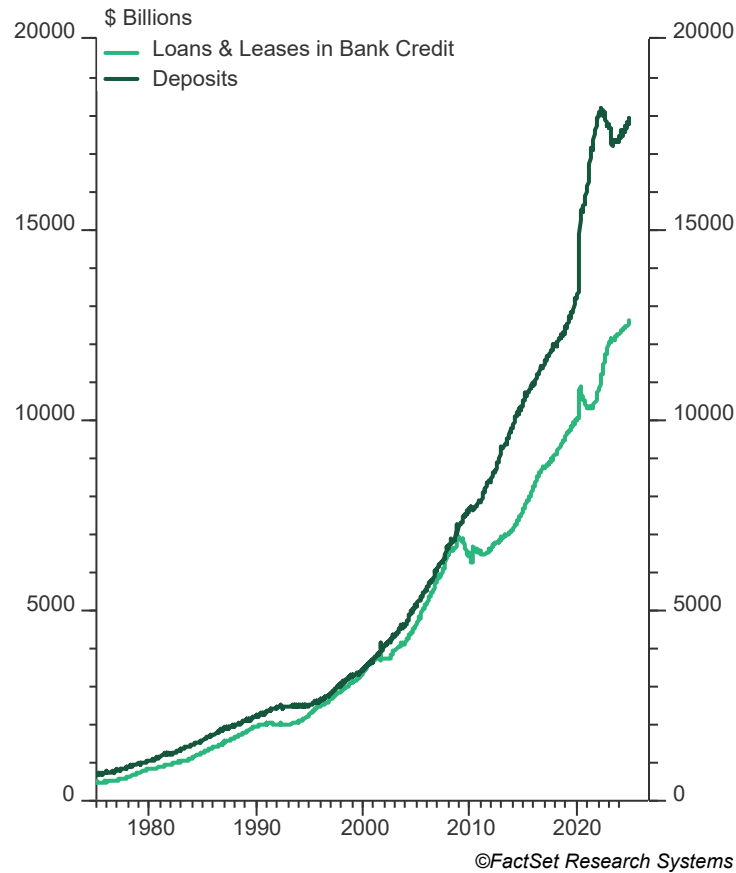


Businesses Plan Price Increases

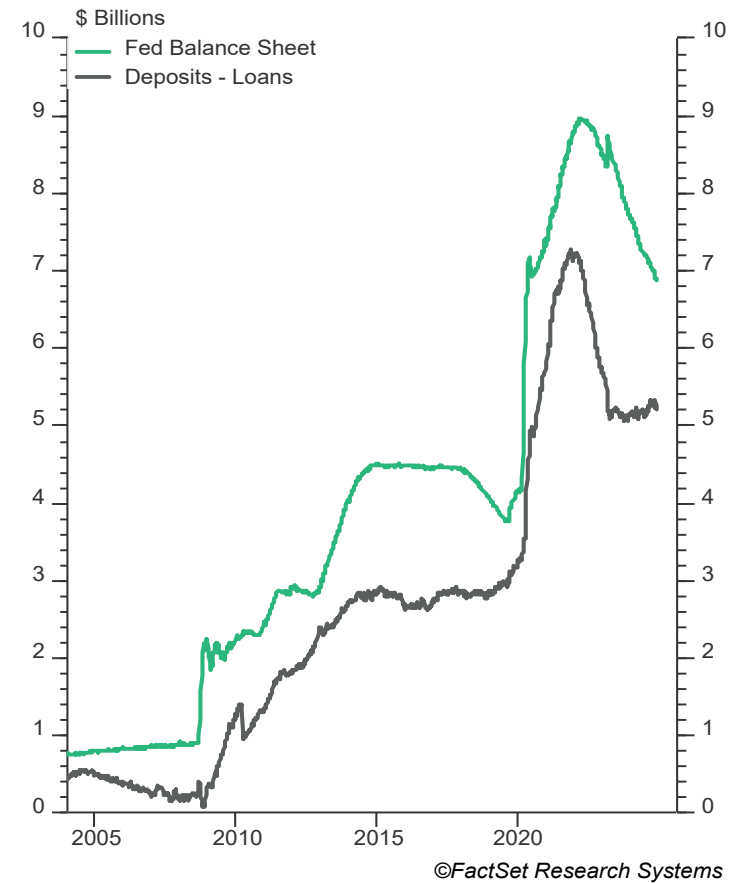


Credit Growth has Lagged Deposit Growth

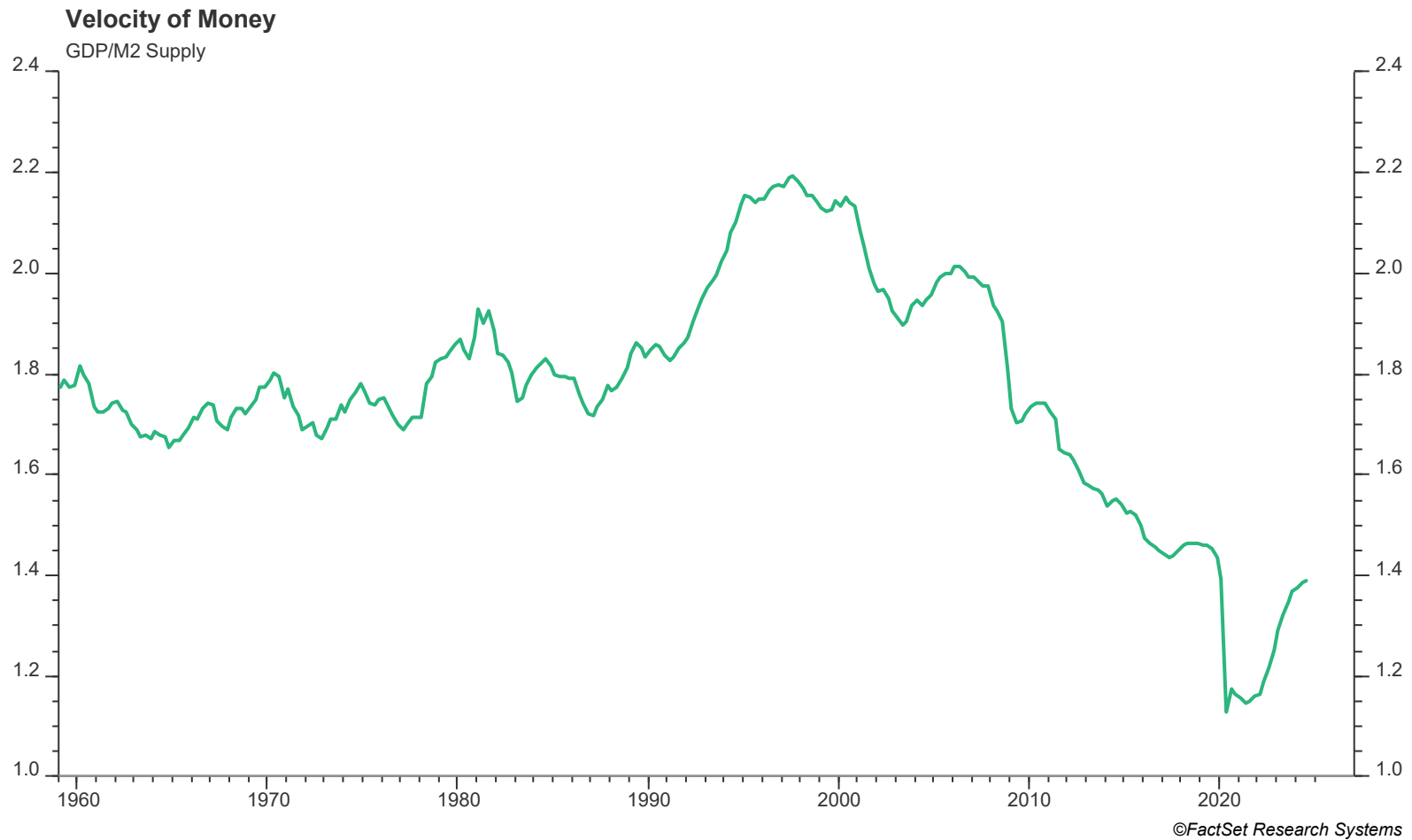
US Commercial Bank Loans and Deposits



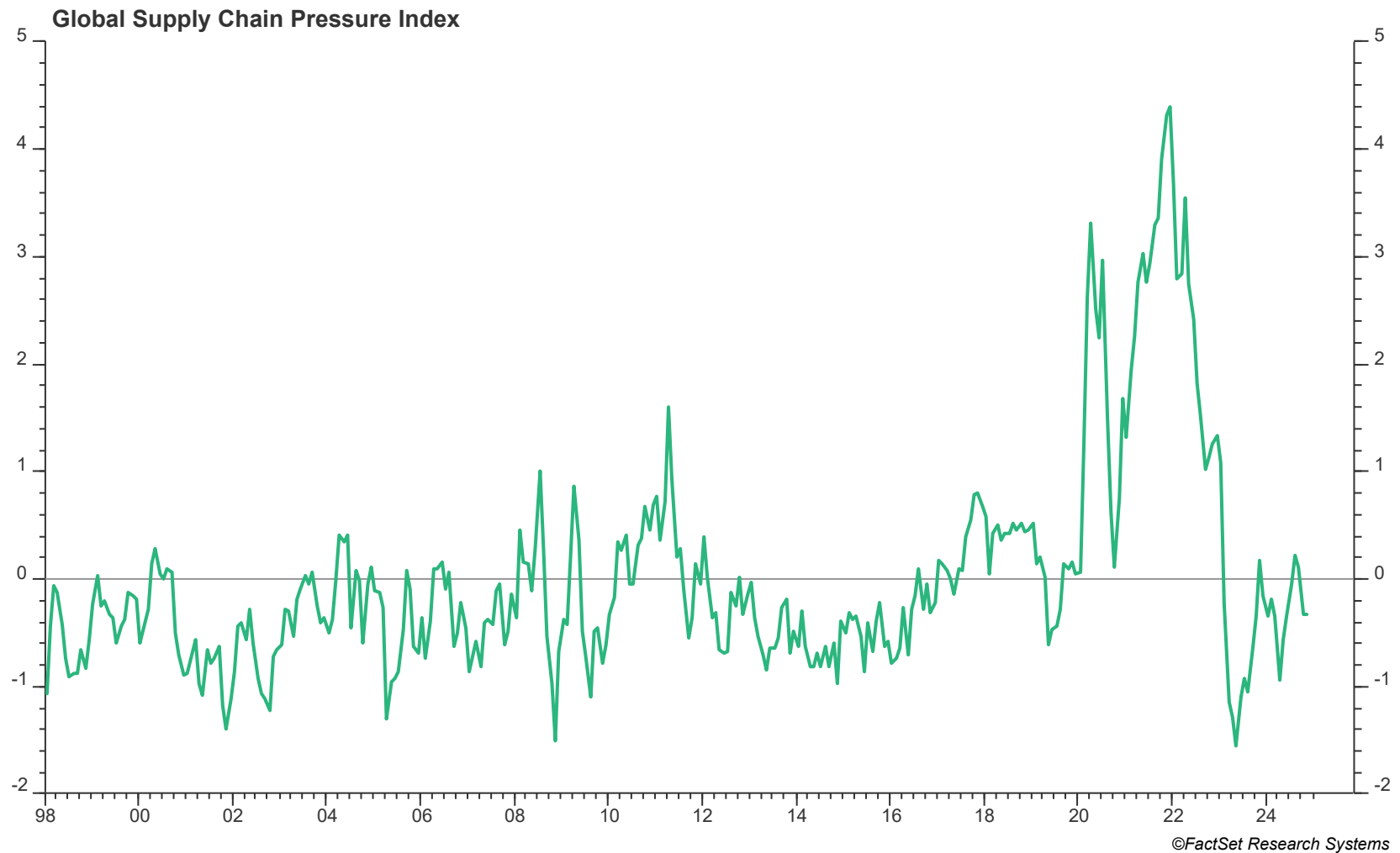
Fed Balance Sheet and Deposit Growth



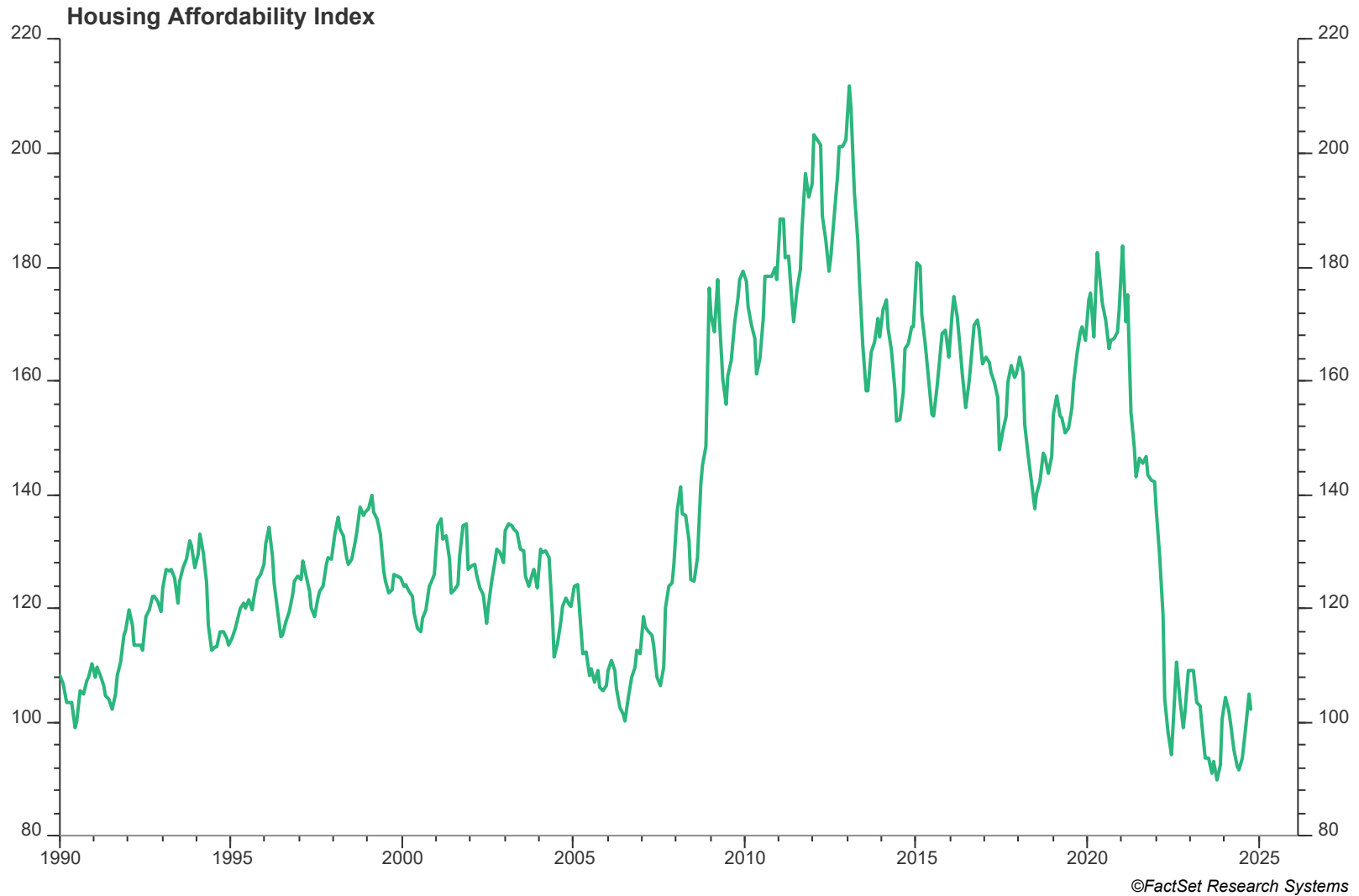
Velocity of Money Near All-Time Lows



Supply Chain Normalization



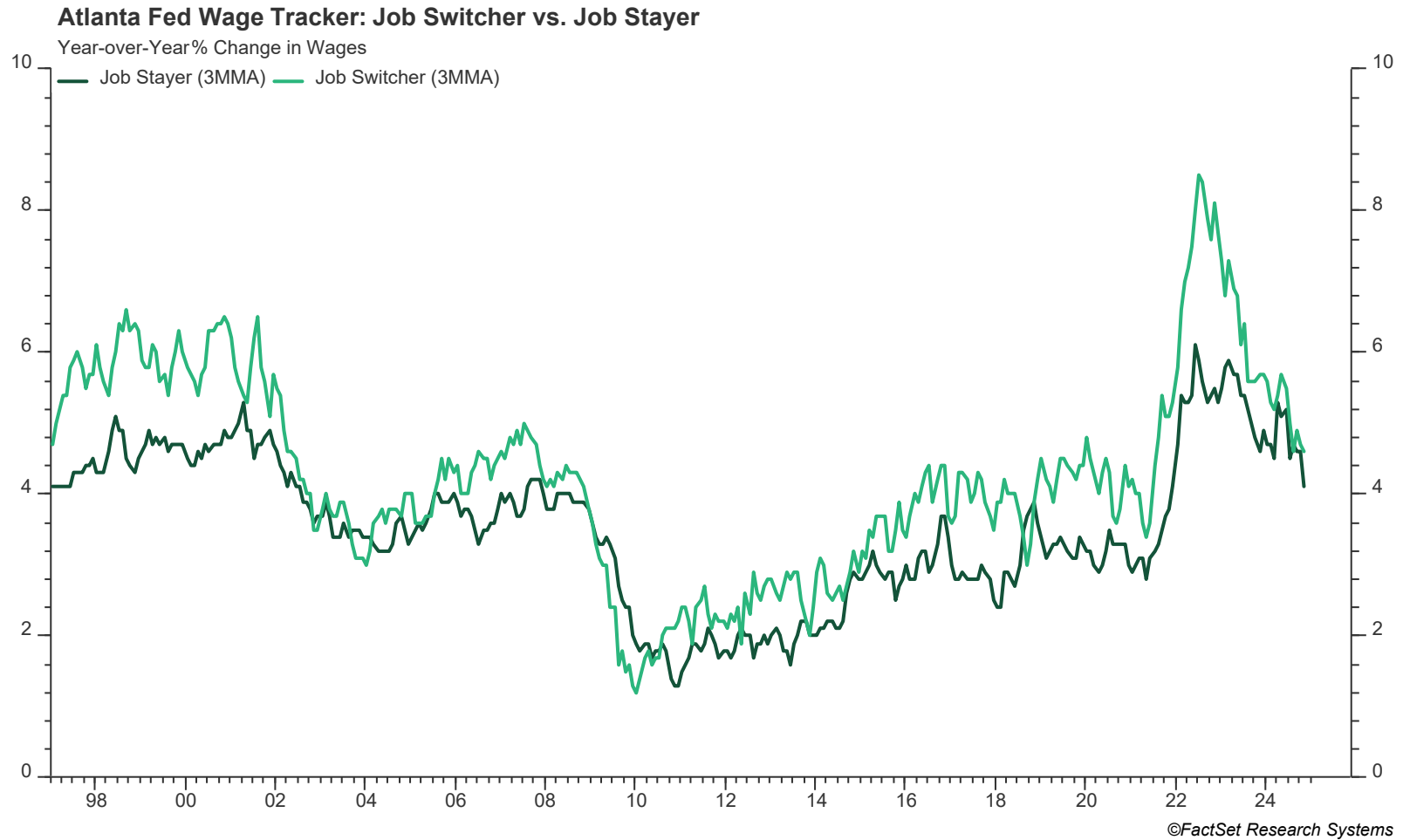
Housing Affordability Has Declined



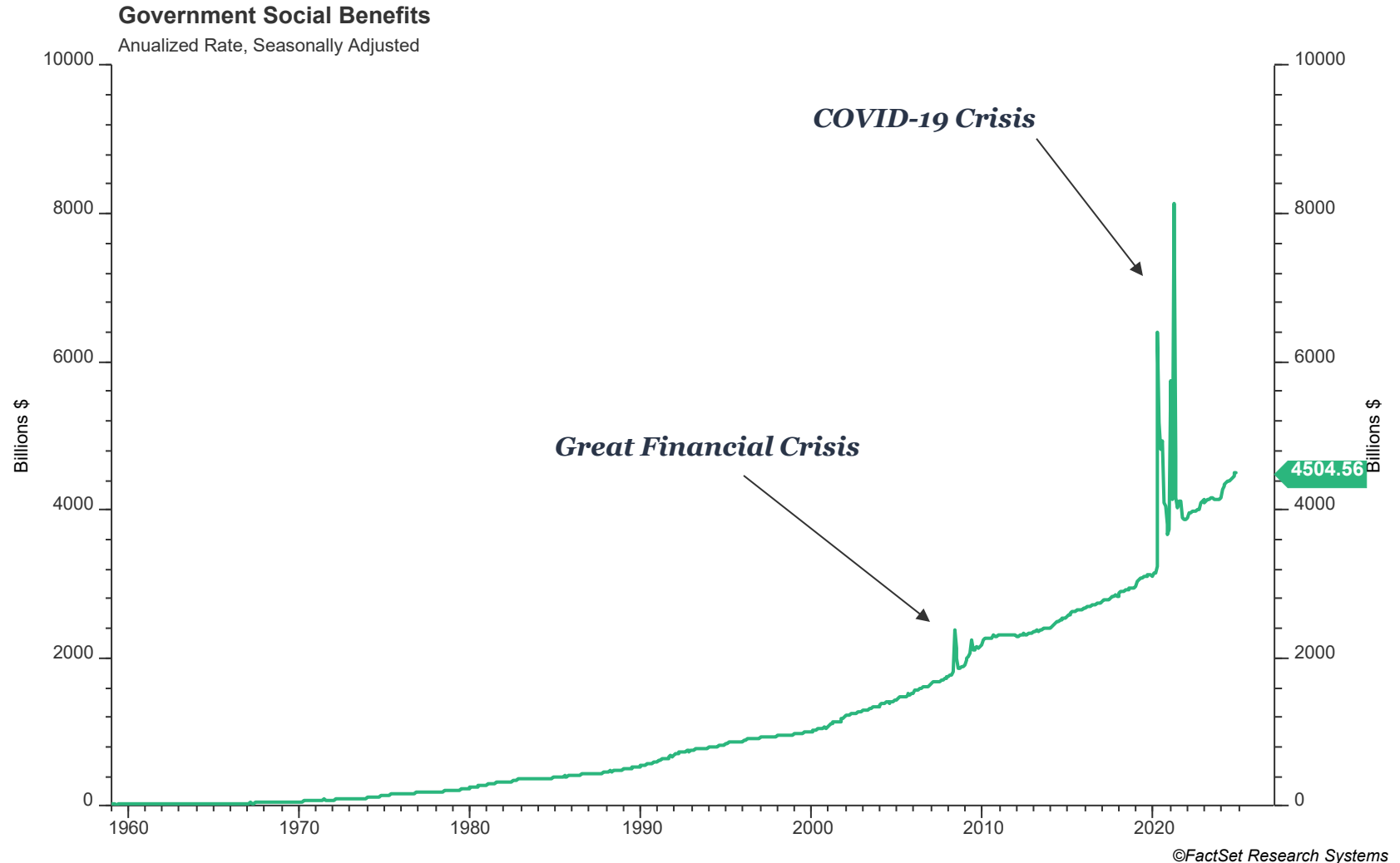
Strong Domestic Labor Market



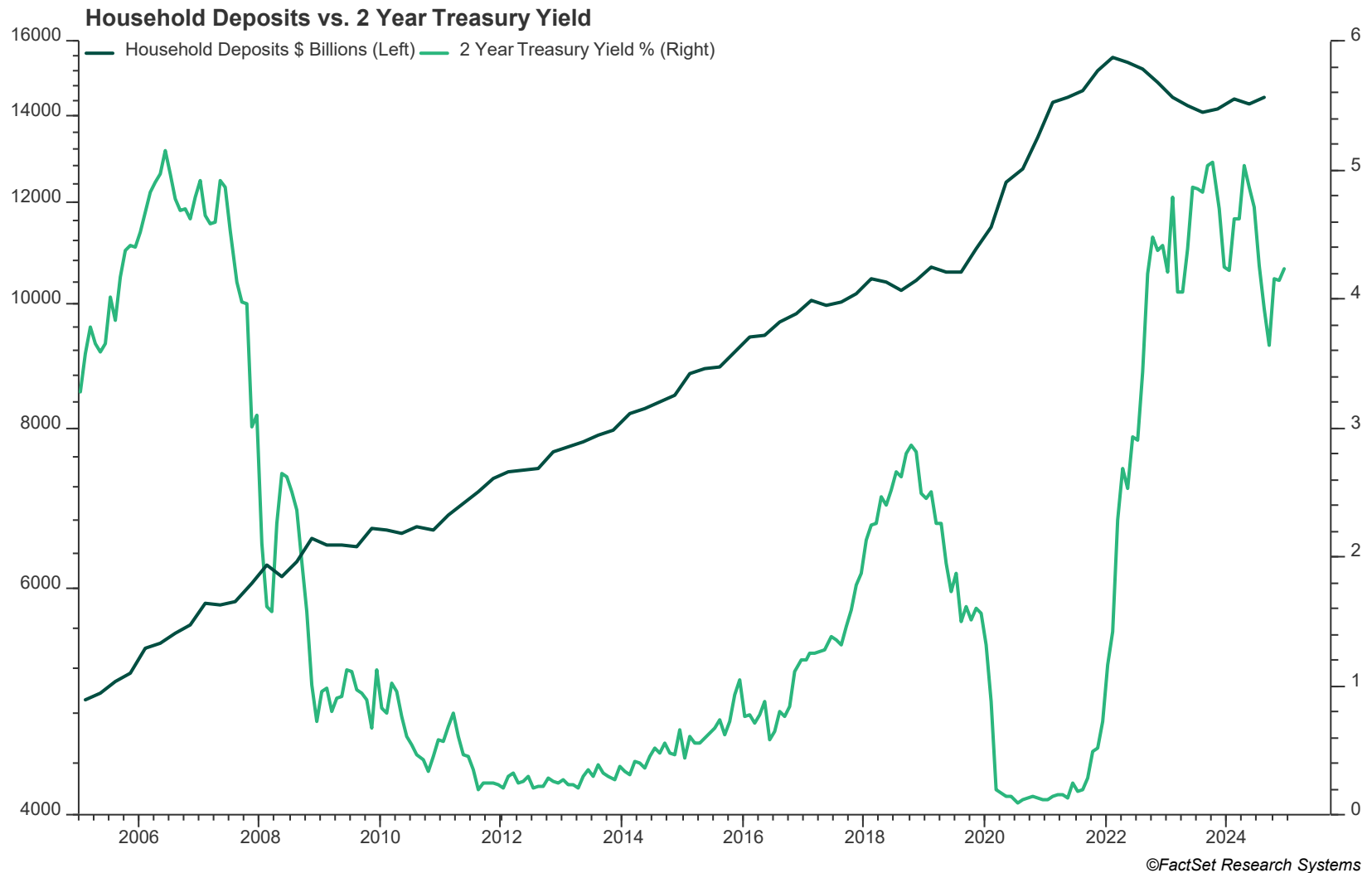
Wage Inflation High but Moderating



Rapid, Large-scale Support for the Economy

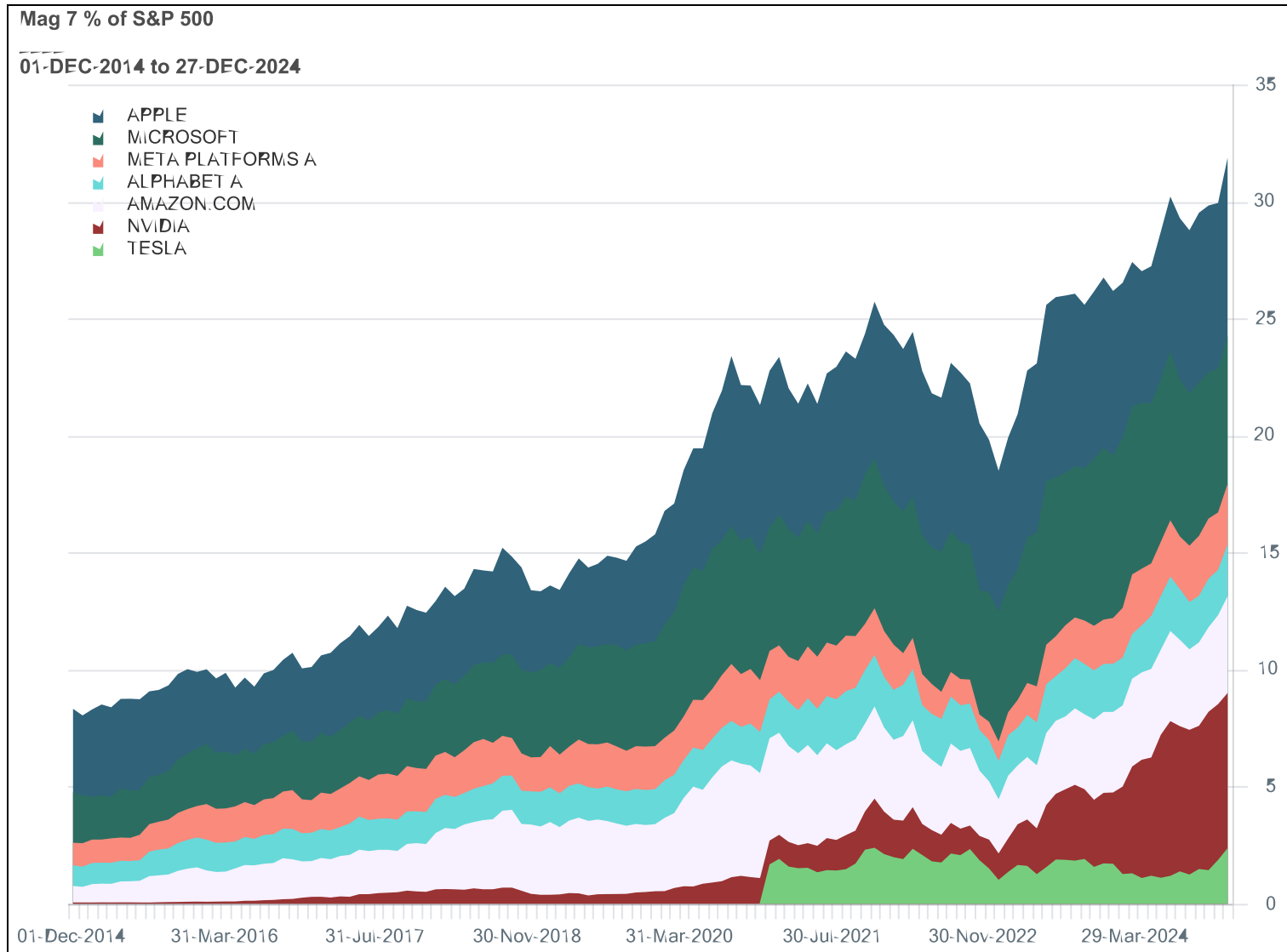


Households Hoard Stimulus



Appendix

Historical Market Concentration



Source: FactSet

31 Years of Market Returns

# of Years Forward	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
1	10%	1%	38%	23%	33%	29%	21%	-9%	-12%	-22%	29%	11%	5%	16%	6%	-37%	26%	15%	2%	16%	32%	14%	1%	12%	22%	-4%	31%	18%	29%	-18%	26%
2	6%	18%	30%	28%	31%	25%	5%	-11%	-17%	0%	19%	8%	10%	11%	-18%	-11%	21%	8%	9%	24%	23%	7%	7%	17%	8%	12%	25%	23%	3%	2%	
3	15%	20%	31%	28%	28%	12%	-1%	-15%	-4%	4%	14%	10%	9%	-8%	-6%	-3%	14%	11%	16%	20%	15%	9%	11%	9%	15%	14%	26%	8%	10%		
4	17%	23%	30%	26%	17%	6%	-7%	-5%	-1%	4%	15%	9%	-5%	-1%	-1%	-2%	15%	16%	16%	15%	14%	12%	7%	14%	16%	18%	13%	12%			
5	20%	24%	28%	18%	11%	-1%	-1%	-2%	1%	6%	13%	-2%	0%	2%	0%	2%	18%	15%	13%	15%	16%	8%	12%	15%	18%	9%	16%				
6	22%	24%	24%	13%	4%	4%	1%	-1%	3%	6%	2%	2%	3%	2%	2%	6%	17%	13%	12%	16%	12%	12%	13%	17%	11%	12%					
7	22%	18%	16%	7%	8%	5%	2%	1%	3%	-2%	6%	4%	3%	4%	6%	7%	15%	13%	14%	13%	15%	13%	15%	11%	13%						
8	17%	14%	10%	9%	8%	5%	3%	2%	-3%	2%	7%	4%	4%	7%	7%	7%	14%	14%	11%	15%	15%	15%	10%	13%							
9	14%	9%	12%	10%	8%	6%	4%	-4%	0%	3%	6%	5%	7%	8%	6%	7%	15%	12%	13%	15%	17%	11%	12%								
10	9%	11%	12%	9%	8%	6%	-1%	-1%	1%	3%	7%	7%	8%	7%	7%	8%	13%	14%	14%	17%	13%	12%									
11	11%	11%	11%	10%	8%	1%	1%	0%	1%	4%	9%	8%	7%	8%	8%	7%	15%	14%	15%	13%	14%										
12	11%	11%	12%	9%	3%	3%	2%	1%	3%	6%	10%	7%	7%	9%	7%	9%	15%	15%	12%	14%											
13	10%	11%	11%	5%	5%	4%	2%	2%	5%	7%	9%	8%	9%	8%	9%	10%	16%	12%	13%												
14	11%	11%	7%	6%	6%	4%	3%	4%	5%	6%	9%	9%	8%	9%	9%	11%	13%	13%													
15	10%	6%	8%	7%	5%	4%	5%	4%	5%	7%	10%	8%	9%	10%	11%	9%	14%														
16	7%	8%	8%	6%	6%	6%	5%	4%	5%	8%	9%	9%	10%	11%	9%	10%															
17	8%	8%	8%	7%	7%	6%	5%	5%	6%	7%	10%	10%	11%	9%	10%																
18	8%	8%	9%	8%	8%	6%	5%	5%	6%	8%	11%	11%	9%	10%																	
19	8%	8%	10%	9%	7%	6%	6%	5%	7%	9%	11%	9%	10%																		
20	8%	9%	10%	8%	8%	7%	6%	6%	7%	10%	10%	10%																			
21	9%	9%	9%	8%	8%	7%	7%	7%	8%	8%	11%																				
22	9%	9%	10%	9%	8%	8%	7%	8%	7%	9%																					
23	9%	9%	10%	8%	9%	8%	8%	6%	8%																						
24	9%	10%	9%	9%	9%	9%	7%	7%																							
25	10%	9%	10%	10%	10%	8%	8%																								
26	9%	10%	11%	10%	9%	8%																									
27	10%	10%	11%	9%	9%																										
28	10%	11%	10%	10%																											
29	11%	10%	10%																												
30	10%	10%																													
31	10%																														

Calendar-Year Annualized Forward Returns

For any given year, 1993 – 2023 (X-axis), the chart provides the annualized return after a number of years (Y-axis).

Example: If you invested in the S&P 500 on 1/1/1993, the 5-year annualized return was 20%. The 31-year annualized return was 10%.

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For any given year, 1993 – 2023 (X-axis), the chart provides the annualized return after a number of years (Y-axis).

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Source: Ritholtz Wealth Management, A Wealth of Common Sense blog, Sept. 4, 2024