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MARKET INSIGHTS

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WELLINGTON-ALTUS

THE BEST OF TIMES, THE WORST OF TIMES:

A Year in Review

As we reflect on the market journey from late 2023 to the present and look ahead to 2025, the resilience and dynamism of the global economy stand out as defining characteristics. Throughout this period, a bullish outlook has been maintained, often swimming against the tide of mainstream opinion. This perspective has proven valuable as markets navigated through complex economic and political terrains, embodying the Dickensian sentiment of the best, and worst of times.

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> It was the best of times; it was the worst of times …
>
> - Charles Dickens

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The 2023 Market Forecast: A Pause that Refreshes

At the dawn of 2023, we predicted a year marked by the return of data dependency and the continuation of the secular bull market for equities. Drawing parallels to the 1994-95 market roadmap, we suggested that the U.S. Federal Reserve would not tighten to the point of causing a global financial crisis. An ambitious S&P 500 target of 4,800 was set for 2023, emphasizing that the 2022-23 episode was merely a pause that would refresh the secular bull market.

This view stood in stark contrast to many analysts predicting prolonged economic difficulties. The accuracy of this forecast was validated as the year unfolded, with markets demonstrating remarkable resilience in the face of ongoing economic uncertainties. This resilience was underpinned by adaptive corporate strategies, technological advancements, and the gradual normalization of pandemic supply chain disruptions.

The market's ability to weather geopolitical storms, including ongoing tensions between major global powers and regional conflicts, further underscored its robustness. Investors who maintained faith in the market's long-term growth potential were rewarded, while those who succumbed to pessimism missed out on significant gains.

Challenging the Permanent Inflation Narrative

Throughout 2023 and into 2024, we consistently challenged the prevailing narrative that inflation would remain persistently high. Our view held that inflationary pressures were largely transitory, driven by pandemic-related supply chain disruptions and extraordinary fiscal stimulus. As these factors normalized, we argued that inflationary pressures would naturally abate.

A key insight that set our analysis apart was the recognition of seasonal patterns in inflation data. We disagreed with the Federal Reserve's interpretation of the first quarter inflation pickup as a sign of reigniting inflation. Instead, we noted that inflation frequently follows a seasonal pattern, peaking in the first quarter as one-time yearly price increases are implemented.

This understanding of seasonal patterns proved crucial for investors and policymakers alike. It allowed for a more nuanced interpretation of economic data, preventing knee-jerk reactions to short-term fluctuations that could have led to misguided policy decisions or investment choices.

Another critical factor in our inflation analysis was the recognition that the Consumer Price Index (CPI) is now primarily driven by lagging variable shelter costs. This insight helped explain the persistence of certain inflationary measures even as other economic indicators pointed towards disinflation.

The shelter component of CPI, which includes rent and owners' equivalent rent, tends to lag real-time changes in the housing market by several months. This lag created a situation where headline inflation figures remained elevated even as other price pressures eased. Understanding this dynamic provided a more accurate picture of the underlying economic inflationary trends, allowing for better-informed decision-making.

The Political Landscape and Economic Policy

As the 2024 presidential election approached, we advised investors to position themselves for a potential Donald Trump victory. This recommendation was based on a clear-eyed analysis of market implications, recognizing that a second Trump administration would likely pursue policies favourable to certain sectors of the economy and potentially accelerate deregulation efforts.

The anticipation of a Trump victory led to strategic positioning in sectors expected to benefit from his policies, such as energy, finance, and defence. This foresight proved valuable as these sectors saw significant gains in the aftermath and market reaction to Trump's win. With the Republicans in control, an era of deregulation and innovation is upon us.

Following the U.S. presidential election, analysis shifted to the implications of the "American System 2.0" economic agenda. This modern iteration of historical economic policies emphasizes protectionism, government efficiency, deregulation, and tax reform. While Trump's policies were

seen as pro-growth, they were not considered as radical as the Modern Monetary Theory (MMT) experiments pursued under the Biden administration.

The Trump administration's focus on government efficiency and deregulation is expected to have a deflationary impact, potentially easing some of the inflationary pressures that have persisted in certain sectors of the economy. This approach, combined with proposed tax cuts, could stimulate economic growth while simultaneously addressing concerns about government spending and inflation.

The Energy Revolution and Deflationary Pressures

With Trump's "Drill Baby Drill" policy and data pointing to a demand slowdown, we expect the Organization of the Petroleum Exporting Countries (OPEC) to defend market share in 2025, much as it did in 2014. This leads to our base case of a US$50 target for oil in 2025, reinforcing deflationary pressures.

The energy sector is poised for significant changes under the new administration. The push for increased domestic oil and gas production is expected to not only impact energy prices but also have broader implications for U.S. energy independence and geopolitical positioning. However, this policy direction also raises questions about long-term sustainability and environmental impacts, creating a complex landscape for investors in the energy sector.

In a world of excess capacity, markets left to their own devices tend to be deflationary. We anticipate companies cutting prices to defend market share in 2025, adding to deflationary pressures. Furthermore, the focus on government efficiency by figures like Trump and Elon Musk is inherently deflationary.

This deflationary environment presents both challenges and opportunities. While lower prices can benefit consumers, they can also squeeze corporate profits and potentially lead to wage stagnation. Investors will need to carefully navigate this landscape, potentially favouring companies with strong market positions and efficient operations that can maintain profitability even in a deflationary environment.

The Bullish Call on Bitcoin and Gold

My July 2024 Market Insights included a notable bullish call on bitcoin and gold. As of November 11, 2024, market data supported this bullish outlook, with bitcoin trading at US$81,750 and gold futures priced at US$2,659.50, both near their year-to-date highs. This strong performance underscores the ongoing demand for alternative assets in an uncertain economic environment. These assets have increasingly been seen as hedges against both inflationary and deflationary pressures, as well as geopolitical uncertainties. Their rise also reflects a growing distrust in traditional financial systems and a search for assets perceived as being outside of government control.

The crypto landscape underwent significant changes during this period, with increased regulatory scrutiny leading to a shakeout. However, this also paved the way for more robust and compliant crypto businesses to emerge, setting the stage for a more mature and integrated crypto ecosystem in the years to come.

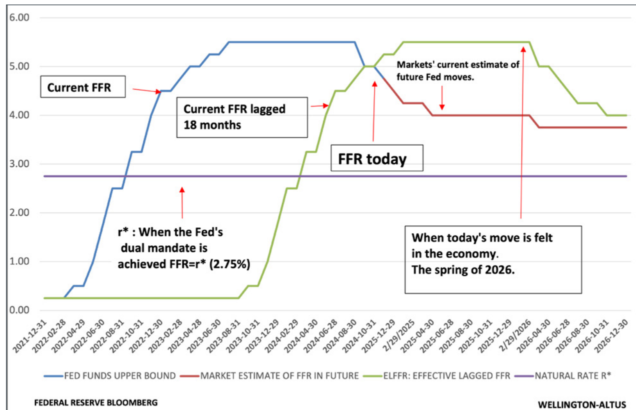
Forecast for 2025 and Beyond

Looking ahead to 2025, we expect continued growth, albeit with some caveats. S&P 500 earnings are projected to rise by 15 per cent, reaching just over US$279.00, and the S&P 500 index could approach 7,000 by late 2025. However, investors are cautioned to be prepared for a potential growth scare in late 2025 into 2026. Innovation, banks and bitcoin are my favourite sectors for 2025.

A key theme for 2025 is the expected divergence between the performance of financial markets and the real economy. While we anticipate risk assets to appreciate, we also expect the real economy to slow down. This dichotomy is largely due to the lagged effects of monetary policy.

We expect the Federal Reserve to continue normalizing interest rates, potentially reaching a target rate of around 2.75 per cent. However, the real economy will still be grappling with the effects of higher rates from previous years. The effective lagged federal funds rate (FFR) is expected to remain around five per cent throughout 2025, acting as a drag on economic growth even as financial markets potentially thrive.

FFR Rate of 5% Baked in Until Early 2026



This situation creates a complex environment for investors and policymakers alike. While rising asset prices may create a wealth effect and boost consumer confidence, the underlying economic fundamentals may be less robust. This divergence between financial market performance and real economic conditions is not sustainable in the long term, potentially setting the stage for market corrections or economic adjustments in the future.

By 2025, we believe the Federal Reserve will have largely achieved its dual mandate of price stability and maximum sustainable employment. This achievement could lead to a more neutral stance from the central bank, with less need for aggressive policy actions.

However, achieving these goals doesn't necessarily translate to smooth sailing for the economy. The lagged effects of previous policy decisions will continue to impact various sectors differently. Moreover, new challenges may emerge, requiring ongoing vigilance and potentially new policy approaches from the Federal Reserve and other economic policymakers.

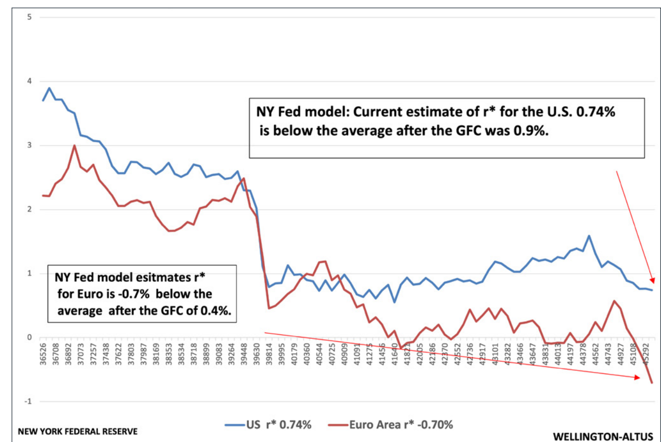
The Deficit Dilemma and Growth Strategy

The deficit issue remains a critical long-term concern. While expansionary fiscal policies may boost growth in the short term, debt accumulation could limit future policy options and potentially lead to financial instability. Investors and policymakers will need to grapple with these long-term implications even as they navigate the more immediate economic landscape.

There is a historical precedent for addressing such significant debt burdens. The path out may mirror the approach following the Second World War—growing our way out of it. The key lies in ensuring that nominal gross domestic product (GDP) growth outpaces inflation, which in turn exceeds the FFR.

While some respectable voices criticize this approach as "inflating our way out of the mess," it's crucial to understand this doesn't necessarily imply high inflation rates. Rather, it suggests a carefully balanced economic environment where both inflation and nominal GDP growth rates are higher than the FFR. Given the Federal Reserve's inflation target of two per cent, this strategy inherently requires interest rates to drop below two per cent to be effective. The New York Federal Reserve's forecast of the natural rate of interest—the rate the FFR should be at—is now below levels seen in the post-Global Financial Crisis era, pointing to the risks of the central bank being too late. Nothing has been fixed.

New York Federal Reserve Estimate of the Natural Rate of Interest



This approach requires a delicate balance. While moderate inflation can help erode the real value of debt over time, excessive inflation could lead to economic instability and other unintended consequences. The goal is to create an environment where economic growth outpaces both inflation and interest rates, allowing for a gradual reduction in the debt burden relative to the size of the economy. Prominent figures

on Wall Street are openly doubting Musk's ability to achieve his objective of US$2 trillion worth of government cuts. He is forthright that economic pain will ensue. In 2025 we forecast government spending shifting from a tailwind to a headwind for growth.

Several factors are exerting deflationary pressures on the economy, including debt levels, demographic trends, technological innovation, and global excess capacity. These deflationary forces will play a crucial role in shaping the economic landscape and the effectiveness of this growth strategy.

This strategy aligns with our earlier predictions of interest rates bottoming out below two per cent in the mid to late 2026 timeframe. It also underscores the importance of policies that promote sustainable economic growth, as growth will be key to addressing the deficit challenge in the long term.

The AI Revolution and Economic Transformation

The transformative potential of artificial intelligence (AI) on the global economy is a recurring theme. The AI revolution is seen as a double-edged sword—offering unprecedented opportunities for productivity growth and innovation, while simultaneously posing challenges to traditional employment structures and economic models.

As AI continues to advance, its impact on various sectors of the economy is expected to accelerate. This could lead to significant shifts in employment patterns, with some jobs becoming obsolete while new ones are created. The distribution of the benefits of AI-driven productivity gains will be a key economic and political issue, potentially exacerbating existing inequalities if not managed carefully.

The integration of AI into various industries is likely to drive efficiency gains and create new business models. However, it may also lead to increased market concentration as companies that successfully leverage AI gain competitive advantages. Policymakers will need to grapple with how to ensure that the benefits of AI are broadly distributed while still incentivizing innovation and investment in this transformative technology.

Conclusion: Navigating the Path Ahead

As we navigate through 2025 and beyond, it's clear that the global economy is at a pivotal juncture. The interplay between monetary policy, fiscal decisions, technological advancements, and geopolitical factors will shape the economic landscape in ways that may challenge conventional wisdom.

Successfully navigating this complex environment will require a combination of foresight, flexibility, and a willingness to challenge prevailing narratives when the data suggests a different story. The ability to discern signal from noise, to see beyond short-term fluctuations to longer-term trends, will be more crucial than ever.

As we've seen throughout this analysis, from the seasonal patterns of inflation to the lagged effects of monetary policy, understanding these nuances can make all the difference in rendering informed economic and investment decisions. The coming years may indeed be "the best of times" for those who can successfully traverse this complex landscape, and "the worst of times" for those caught unprepared.

With careful analysis, strategic thinking, and a willingness to adapt, we can strive to make the most of the opportunities that lie ahead, while building resilience against the inevitable challenges we will face. As we conclude this economic outlook, it's worth remembering that in every challenge lies an opportunity, and in every risk, a potential reward. The path ahead may be uncertain, but for those prepared to navigate its twists and turns, it offers the potential for significant growth and prosperity.

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