Post-Election: Growth, Inflation, and Caution in 2025

With the long-awaited and highly consequential U.S election finally coming to a resolution, markets quickly shifted focus to the anticipated implications of a second Trump presidency alongside a Republican sweep of both houses of Congress. Key policy changes related to tariffs, immigration, corporate taxes, and deficit spending were quickly extrapolated for the expected impact on the economy and subsequent Fed reaction.

As we close out the year and head into the new administration's inauguration, markets have converged around a consensus view that Trump's pro-growth and U.S.-centric policies will support economic activity but also create additional price pressures. This backdrop suggests the need for a more cautious and data-dependent approach to monetary policy, with fewer Fed cuts being priced in for 2025 following the results of the election. As of this writing, markets are pricing in a terminal Fed Funds (FF) policy rate of 3.75-4% by the end of 2025. Supporting this theme is the expectation that the economy will continue to grow at a solid pace in 2025, albeit at a slightly slower pace. Labor markets continue to remain stable, and consumers continue to be in a generally healthy position to spend.

The top-down macro data generally corroborates this theme, but as bottom-up credit fundamentalists, we see enhanced value in deriving additional macro themes from the companies we cover, offering a more precise and timely perspective on economic trends. With third quarter earnings coming to a close, we have provided high-level summaries of key themes aggregated from company commentary below.

Labor markets:
According to company commentary in the aggregate, labor markets can be categorized as healthy, though currently stagnant or softening. While there have been a few notable firing announcements (BA, VW, INTC), layoffs are not broad-based, and the majority of the announcements have been more of a rationalization to trim excess and optimize cost structures (typically 1-4% of total workforce layoffs). The companies that are laying off a meaningful portion of their workforce are going through idiosyncratic struggles, are smaller in size, and not representative of the overall market dynamics. On the opposite end, there are very few large-scale hiring announcements, so the overall trends indicate a continued softening of conditions. Holistically, for individuals who currently have a job, spending levels are likely to continue. However, for those recently laid off or seeking to enter the workforce, securing skilled labor positions has become more challenging. Jobs paying competitive wages are still available, but are not as prevalent in industries that hoarded labor during 2021 and 2022, as companies look to rationalize labor through attrition as growth slows and uncertainty builds.

Inflation:
Commentary around current and forward inflationary pressures is relatively limited and concentrated in very specific industries, notably airlines in 3Q24, which expect positive pricing fundamentals on lower capacity due to issues at OEMs and route rationalization actions taken to address slower demand from 2023 peak. What has consistently come up has been the cumulative pressures of inflation on consumer consumption habits, driving value-seeking behavior. One of the lingering inflationary pressures companies continue to mention if the topic does arise is elevated wage and compensation costs. These are broadly being offset by lower costs in other areas such as commodity, freight, and productivity initiatives, meaning labor as a lever to pull to address margin contraction is not a broad-based theme. Some companies are still raising prices, but at a more normalized clip, similar to pre-pandemic rates. Others are actively reducing prices or being extra sensitive to price increases in an effort to drive volume growth and address slowing demand. In aggregate, pressure from companies taking price to drive top-line growth has abated, and it is not expected to pick up going forward, unless reacting to idiosyncratic issues such as tariffs or spikes in single commodities like coffee.

Consumers:
Commentary around consumers appears to be highly dependent on the industry or sector, but compiling commentary across all sectors paints a picture of a consumer that is still healthy and continues to spend, but is more intentional about where discretionary dollars go. Consumption is not broad-based; people generally are trading down in essentials (consumer staples, groceries, general merchandise) and are using the dollars saved in those categories to spend in other areas such as travel, leisure, and restaurants. Larger ticket discretionary items, especially those that are typically financed (housing, autos, home improvement, appliances, sport craft) have been under pressure due to higher for longer rates and tougher affordability. Higher-income

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consumers (>$100k) are trading down to wholesale clubs and value-based retailers. Consumers are generally healthy, still experiencing wage growth, and have good job security with access to multiple forms of credit to continue spending. However, spending is not at the same robust pace and continues to soften on the margin.

Growth/Outlook:

Forward outlooks are not uniform, but generally the sectors that have been under pressure are expecting flat performance in 2025, while sectors that have seen strong growth in 2024 expect positive fundamentals to continue, but at a slower pace. Overall, forward outlooks are indicative of slowing but still positive growth from 2024. General business optimism has increased following the results of the election, but there will be winners and losers with the new administration's policies.

Broad company commentary generally aligns with top-down macro data and current market sentiment, highlighting that the current fundamental backdrop for the U.S economy is overall positive. Despite this view, markets are pricing this outlook to near perfection, with little accommodation for potential risks on the horizon. It's unclear to what extent the anticipated policies will be enacted in Washington or the subsequent implications on the economy, but we anticipate a high level of volatility associated with the new administration. With risk compressed and credit spreads at historic tights, we continue to maintain a defensive posture within portfolios to account for the litany of potential risks on the horizon, utilizing elevated liquidity positioning to take advantage of expected market volatility. We believe 2025 will be dynamic and provide exciting opportunities for active management.

Thank you for taking the time to read our thoughts and for your continued partnership and trust in Smith Capital Investors.

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