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COLONIAL TRUST *Quarterly*

Capital Markets Review

2025 Expectations

In The Spotlight with Brittany

CAPITAL MARKETS REVIEW

The S&P 500 finished 2024 with positive returns for the quarter and the year. The S&P posted a total return of 25.0% in 2024, after returning 24.2% in 2023. The last time the S&P rose more than 20% for two consecutive years was 1996-1997. Nonetheless, the quarter ended with more of a whimper than a roaring bull, as the Santa Claus rally never came, and markets were down for December.

The performance of the market narrowed in the quarter, after broadening out for parts of 2024. The Dow rose less than 1% for the quarter, while the Nasdaq returned 6.4%. The Russell 2000 index returned 0.3%. International markets fared much worse than the US, with the MSCI EAFA developed market index down 8.1% and MSCI Emerging Markets down 7.9%. Long-term interest rates rose, despite the Fed cutting rates. The US Aggregate Bond Index declined 3.1%. The 10yr treasury yielded 3.62% before the Fed began cutting rates in September and then ended the year at 4.57%.

Index	4Q	Total Return
S&P 500	2.4%	25%
DJIA	0.9%	15%
Nasdaq	6.4%	29.6%
Russell 2000	0.3%	11.5%
MSCI EAFE	-8.1%	4.4%
MSCI Emerging Markets	-7.9%	8%
US Agg Bond Index	-3.1%	1.3%

Source: Bloomberg, LP

The market rose post-election with all eleven sectors up in November. The leadership included financials, industrials, energy, and consumer staples. The market strength and breadth lost steam in December when the Fed signaled inflation remained a concern and fewer rate cuts should be expected in 2025. This guidance, and rising long-term interest rates, caused traders to move away from the broad market and back to the Magnificent Seven.

Four of the eleven sectors of the S&P 500 were positive for the fourth quarter, offsetting more than 5% declines in the other seven sectors. The market narrowed further in December, with only three sectors in the green: communication services, consumer discretionary, and technology. These three sectors are dominated by the Mag-7 stocks of Amazon, Apple, Alphabet, Meta, Microsoft, Telsa, and Nvidia. The Mag-7 index of these stocks returned 15.9% for the quarter and 6.3% for December.

REVIEW OF OUR 2024 FORECAST

We begin with a review of our 2024 assessment of the economy and markets. We were right in some areas and wrong in others, which is why Yogi Berra said, “It’s tough to make predictions, especially about the future.”

We expected private investment growth to improve, which was correct due to strength in IP and IT equipment for artificial intelligence (AI). We expected investments in manufacturing to continue, which occurred in the first half of 2024, although 3Q data showed weakness. We incorrectly forecasted an improvement in housing, where early signs of life were snuffed out by rising mortgage rates.

We expected deficits to be flat for 2024; however, the deficit situation worsened in 2025 and stimulated the economy. We correctly forecast gridlock preventing the passage of large spending bills, but the deficit is running at 7.1% of GDP, with interest expense a key driver. As of 9/30, the trailing twelve-month interest was $1.117 trillion, up 15% in one year.

We were correct about the consumer, the largest contributor to the economy. We

believed consensus was too bearish on the consumer heading into 2024. We expected the labor market to remain healthy with real wage growth. We highlighted the trillions of Boomer's wealth, which is beginning to flow downstream through gifts and inheritance. Consumer spending was strong in the first three quarters of 2024.

Our forecasts for equities and fixed income returns were directionally correct in that we expected positive equity returns and for the yield curve to dis-invert. We expected the market to broaden and become less reliant on the Mag-7 stocks. This occurred on several occasions in 2024; however, the market remains heavily influenced by the performance of these seven companies. These companies accounted for more than half the S&P 500's performance over the last three years and represent 33% of the S&P 500's market value.

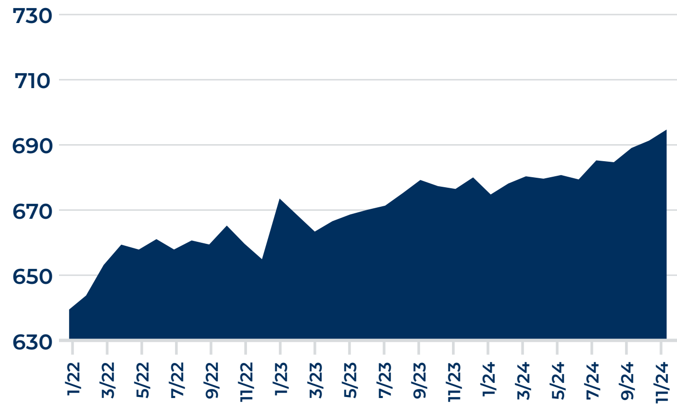
2024 ECONOMIC PERFORMANCE

THE ECONOMY GREW ABOVE TREND IN 2024, WITH GROWTH QUICKENING AS THE YEAR PROGRESSED.

The final read of 3Q GDP was 3.1% growth. This strength was the result of consumer spending, which has grown in every quarter since the pandemic. Consumer spending growth accelerated during 2024 and was 3.7% in 3Q, thanks to the labor market. The economy created 2.2 million jobs in 2024, and real average hourly earnings rose 1.3% year-over-year, with nominal wage growth of 3.9%.

The consumer will reliably spend money if they are employed and see wage gains. This was the case in 2024, where year-over-year retail sales accelerated into year-end. The early data for the holidays is positive according to Mastercard. In addition to wages, spending was aided by rising net worth, which reached $160tn as of September, up $13tn in 2024. Rising stock and home prices have the consumer feeling richer than ever before.

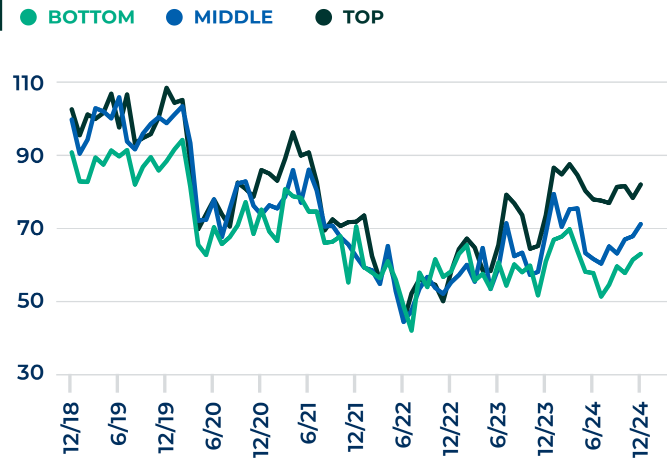
ADJ. RETAIL & FOOD SERVICE SALES



Source: Bloomberg, LP

The consumer is not monolithic. Consumer Sentiment index increased in 2024 as inflation subsided. However, there is a growing divergence based on income, with the lowest 1/3 of income more negative about their prospects. Within this group, we are seeing rising auto and credit card delinquencies.

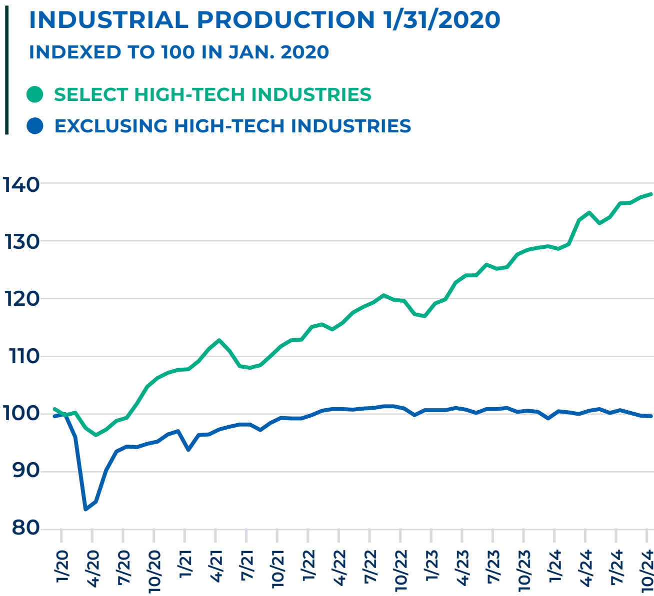
CONSUMER SENTIMENT BY INCOME TERTILE



Source: Bloomberg, LP

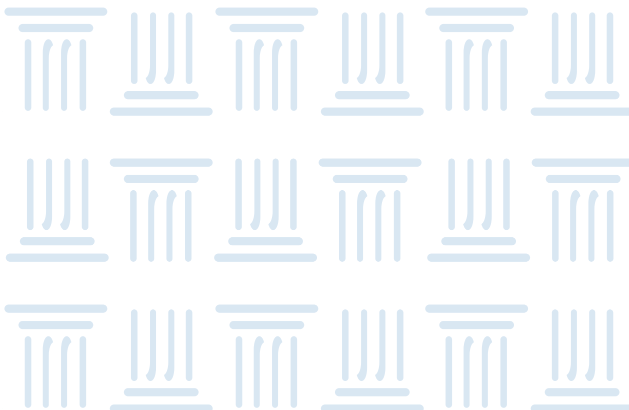
The corporate sector was mixed in 2024. The manufacturing economy remains anemic. The ISM's Purchasing Managers Index contracted in every month of 2024, except March. The exception to this weakness is anything related to AI. Production in high-tech industries has

seen impressive growth over the last four years, while the rest of industrial production has been flat.



The services sector continued to grow in 2024. The Services PMI signaled expansion in all but two months of 2024. Micro data readings, like OpenTable reservations and TSA check-ins, increased in 2024. In 3Q GDP, spending on healthcare services was the fastest growing area of services spending, followed by financial services and insurance.

While we await the release of final 4Q economic data, we expect the economy grew close to 3% in 2024. The US is growing quicker than all major global economies by a wide margin. Our consumer is stronger; businesses are more productive; and our economy more resilient.



OUR EXPECTATIONS FOR 2025

WE BELIEVE THE ECONOMY SHOULD CONTINUE TO GROW ABOVE THE 2.0% TRENDLINE, AS LONG AS THE LABOR MARKET REMAINS HEALTHY.

Consumer spending should moderate in 2025 from the faster pace of 2024. Consensus estimates are for consumption to grow 2.4% in 2025, after rising 3.7% in 2024. We expect job growth to remain positive in 2025. In 2024, the labor market weakened from January through August, before rebounding into year-end. Labor dynamics could be interesting in 2025, if immigration slows, and 4.25 million Boomers turn 65. This will keep the job market tight, even if labor moderates. We expect job gains of 150k per month. We have seen nominal wage growth moderate in 2024, from 4.3% growth in December 2023 to 3.9% in December. Real wages continue to improve as inflation has fallen, which we expect to continue in 2025.

We expect the corporate sector to have the same drivers as 2024. We have yet to see a turn in the manufacturing sector and we are not expecting a broad-based recovery in 2025. An exception is the large projected capital expenditures of $234 billion for AI from Alphabet, Amazon, Meta, Microsoft, and Oracle. This is a 19% increase from 2024 and an 85% increase over 2023. We expect growth in the service sector, the primary driver being the healthy consumer. If the labor market remains stable consumers will have growing income for consumption. In addition to workers, retirees have become large consumers of travel, leisure, and health care services. The net worth of the boomer generation is $78.1 trillion, and they are heathier and more active than their predecessors. We expect this generation to adopt some version of “you only live once” and enjoy the savings they have accumulated over their careers.

Forecasting the impact of fiscal policy is fraught in normal times, and these are not

normal times. As we evaluate the current fiscal situation, we do not expect much change in the deficit situation given that discretionary spending is only 26% of the budget. The interest debt service line is non-negotiable, increasing, and facing higher interest rates. The Tax Foundation estimates a 20% tariff on imported goods will only raise $271 billion in revenue. Trump campaigned on not touching entitlements while simultaneously lowering taxes. DOGE may improve government efficiency, thereby reducing spending, but we are skeptical of Musk's claim of $2 trillion in cuts. Changes in the regulatory regime and pro-growth economic policies may increase tax revenues by quickening economic growth, but we do not expect this to manifest on January 20, 2025.

The biggest issues for the economy and markets may be inflation, which moderated in 2024, but core CPI has been stuck at 3.3% for the last few months. While moderating, shelter costs have not fallen as quickly as other prices. Stubborn inflation has forced the Fed to pause rate cuts after the December meeting. Markets are now expecting only two quarter-point rate cuts in 2025. Inflation break-evens (the difference between treasury and TIPs yields) show market expectations for inflation have risen from around 2.0% to 2.4% during the fourth quarter. We expect inflation to continue to fall in 2025 for a few reasons. First, the measurement of shelter inflation lags, and we see some progress on this front. Secondly, annual inflation is likely to fall in the first quarter as we roll off higher inflationary months of 1Q 2024. The Fed's preferred measure of inflation, PCE, was 0.3%-0.4% in the month-over-month reading in the 1Q of 2024. The last six monthly readings have been between 0.0% and 0.2%. Removing those higher readings and replacing them with the current trends will reduce the annual inflation levels.

WHAT WORRIES US IN 2025?

Investors always have something to worry about. There remain geopolitical concerns – whether Ukraine/Russia, the Middle East, or China/Taiwan. These concerns have been with us for several years and while we may have some resolution on the first two in 2025, China remains a concern.

The new administration is entering with both anticipation and concern. Tariffs could be inflationary or cause trade wars. We believe Trump's bellicose statements are a negotiating tactic to bring nations to the table. We do not expect all threatened tariffs to be imposed, with the caveat of Chinese tariffs. We suspect the recent Chinese hack of the Treasury Department only increases his conviction to retaliate. This may cause supply chain disruptions; however, China needs the US more than we need China. Corporate America has moved away from relying on Chinese manufacturing over the last few years, which will lessen the impact of trade tensions.

We remain concerned about the trajectory of the US fiscal situation. We do not believe 2025 will be the year of reckoning, but the current path is unsustainable, and no party is interested in addressing this.

WHAT MAKES US OPTIMISTIC?

THERE ARE TWO POINTS OF OPTIMISM WE WOULD LIKE TO MENTION.

The first has been called a "Vibe Shift" as outlined by venture capital titan, Marc Andreesen. While consumer sentiment has not seen a dramatic change post-election, the business community has. The NFIB Small Business Optimism index increased from 93.7 to 101.7 in November, the largest jump since 1980. Deloitte's CEO Survey for December showed 84% of CEO are optimistic about their prospects, up from 69% a year ago. Andreesen, formerly a Democrat, has spent half his time in Mar-a-Lago since the election. He points to DOGE and a cadre of folks from the private sector volunteering to help reimagine the government and drive economic growth. Time will tell if this is false hope or if we see real change in government. But we like the idea of our best and brightest minds going to

D.C. to improve our government. If this effort achieves some of their aims, it could cause the economy to outperform.

Secondly, the economy has shifted to a higher level of productivity over the last few years. The US economy saw “productivity booms” in the 1960’s and 1990’s, where productivity growth averaged more than 3% for a decade. The 2010’s saw productivity growth of just 1%, but over the last eight quarters growth has averaged 2.3%. This increase does not capture improvements from AI, which are in their infancy. Productivity growth is the remedy for many economic problems. It results in faster growth, lowers inflation, increases wealth, lowers fiscal deficits, and improves wellbeing. It allows us to create more stuff with less effort. If productivity has shifted to a higher gear, this faster growth will reduce our fiscal strain, and drive markets higher.

WHAT MAY 2025 HOLD FOR CAPITAL MARKETS?

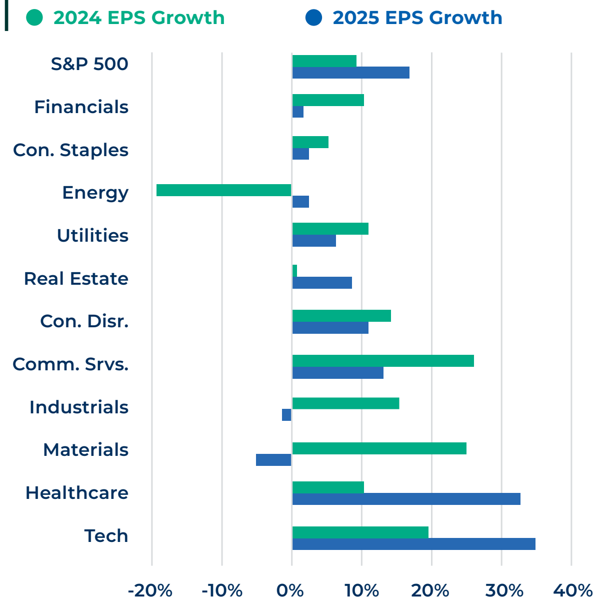
AFTER TWO YEARS OF 20% PLUS RETURNS IN THE S&P 500, WE CANNOT EXPECT ANOTHER 20% YEAR UNLESS THE “VIBE SHIFT” AND PRODUCTIVITY CAUSE RAPID GROWTH.

While hopeful on both fronts, we think those are longer-term trends. For 2025, investors are interested in earnings growth and valuations.

Corporate earnings grew every quarter of 2024, and the pace of growth accelerated each quarter. Based on estimates for the 4th quarter, earnings for the full year should grow 9.2%. The good news is growth is being driven by higher profit margins. The bad news is the earnings growth for the Mag-7 is 34%, while the other 493 stocks in the S&P 500 had 3% growth.

2025 estimates from S&P call for EPS growth of 16%. Wall street is forecasting growth across all eleven sectors, after energy, industrial, and materials sectors reported falling earnings in 2024. The Mag-7 is projected to see earnings growth of 21% in FY25, with the rest of the market posting 13% growth. Within S&P sectors, 2025 earnings growth is forecast to improve in some of 2024’s weakest sectors: healthcare, materials, industrials, and real estate.

S&P EARNINGS GROWTH FORECASTS



We expect earnings growth to be strong for the broad market in 2025 as economic growth drives topline growth and lower inflation and productivity improve margins. We believe this backdrop will be positive for more than seven stocks, broadening out performance.

The market began 2025 valued at 21.5x next year’s earnings. This is an elevated forward price to earnings (P/E) ratio, up from 18.4x when this bull market began in October 2022. This valuation increase reflects optimism about growth prospects and a less hawkish Fed, although the Fed may not be as helpful to markets as believed in September. A deeper dive into valuations shows the forward P/E of the Mag-7 is 37x, while the rest of the market is trading at 18x next year’s earnings. At the sector level, there are many parts of the market that are trading near their 20yr average valuation metrics – including energy, materials, communications services, real estate, healthcare, staples, and utilities. This reminds us we are dealing with a market of stocks and not simply a stock market. There are attractive valuations for certain companies, which should

do well in the future, and there are companies with rich valuations on expectations of rapid growth from innovative technologies. We do not want to exclude these growth opportunities but think there is value in other parts of the market. A strong economic backdrop will lift most boats, and certain boats can be purchased at more reasonable prices.

The consensus year-end price target for the S&P is 6,705, which would imply a 13% increase for 2025. This return and 16% earnings growth would bring a welcome reduction in valuations. We do not expect a straight line to these types of returns in 2025. We have geopolitical risk, a new administration, and uncertainty about interest rate cuts. We expect volatility to increase in 2025, particularly versus the first half of 2024.

The bond market has returned the "old" normal that existed prior to 2009, when rates were above inflation. 2024 ended with the 10yr treasury yielding 4.57%, up from 3.93% at the beginning of the year. Inflation has moderated though it remains above the Fed's 2.0% target and economic growth is above trend. We expect interest rates to remain at higher levels. The wild card is the deficit situation. We are not calling for a reckoning due to fiscal policy, but the markets are concerned about deficits, which will keep rates higher. The spread companies pay above treasury rates are at historic lows – for both high-quality and high yield issuers. This is not outlandish given borrowers see growth in earnings and cash flows, but we do not expect spreads to narrow from here. In an environment where spreads are low and yields are high, we favor short-to-intermediate term debt of highly rated issuers.

We expect 2025 to be a good year for the economy, markets, and hopefully our nation. Market prices are one gauge for how a nation perceives itself. There is private sector optimism going into the new year. If productivity continues to improve and we see gains in government efficiency, this could be a wonderful year. This is certainly our hope as Americans.

BRITTANY NETHERCUTT
Director of Family Office Services

IN THE SPOTLIGHT

Brittany Nethercutt joined Colonial Trust in November 2024 to step into the Director of Family Office Services role. She joined Colonial Trust with four years of accounting advisory experience with Elliott Davis. While with Elliott Davis, she specialized in financial statement and transaction analysis for private companies and non-profit organizations. Before working in the accounting industry, Brittany spent several years working as a licensed insurance sales representative while working to obtain her Bachelor of Science in Accounting. Brittany looks forward to utilizing her experience to help provide exceptional service to our clients.

AN ADDITIONAL NOTE OF GRATITUDE

Jordan Taylor stepped down as our Directory of Family Office Services. She was indispensable in helping our firm develop and customize these specialized services to meet our clients' needs. We are grateful for Jordan's insight and dedication while working at Colonial Trust Company, and we wish her well.

OUR LEADERSHIP

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