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The Wealth Management Division of First County Bank

OUTLOOKS

February 2025

ECONOMIC OUTLOOK

Summary

The U.S. economy finished the year on solid footing as Gross Domestic Product (GDP) for Q4 2024 grew 2.3%. Looking under GDP's hood, we view the U.S. economic engine as healthy. The consumer is the most important component to the economy, with consumption representing just under 70% of GDP. In the fourth quarter consumption contributed 2.8%, outpacing overall GDP. A negative component of GDP this quarter was an inventory build, which detracted 0.9% from GDP. We believe inventories increased during the quarter as companies looked to front run any prospective tariffs by purchasing goods before President Trump took office. The inventory piece of GDP is noisy as it tends to fluctuate throughout the year and this quarter's negative drag likely masks some of the strength in the overall economy.

The Federal Reserve's Open Market Committee (FOMC) met in January and voted to keep the overnight bank funding rate's upper bound unchanged at 4.50%. This decision is the first time in four meetings when the FOMC did not vote to lower interest rates, signaling a "Fed pause." We aren't surprised by the decision to keep the overnight rate unchanged. U.S. growth is solid, the unemployment rate remains historically low and inflation's progress towards the Federal Reserve's 2% target has stalled.

Inflation is lower but the "last mile" is proving to be difficult. The Consumer Price Index (CPI) has declined from its June 2022 peak of 9.1% to a more reasonable 2.9% in December. However, this is an increase from September when CPI was 2.4%. Despite the increase in CPI the Fed maintains its belief inflation is headed lower. The Fed's current stance is to remain "data dependent" at each meeting. This is a fancy way of saying let's wait and see what happens before we decide to cut interest rates any further.

Positives

GDP remains strong and above trend (2.3%)

Unemployment rate remains low (4.1%) and continuing jobless claims are stable

ISM services index came in stronger than anticipated (54.1 vs. 53.5)

Negatives

Headline CPI year-over-year increased for the third consecutive month (2.9%)

Factory orders were negative (-0.9%) for four of the last five months

Durable goods orders were negative (-2.2%) for the second consecutive month

EQUITY OUTLOOK

Summary

The stock market got off to a nice start in January with the S&P 500 Index closing 2.8% higher. Equities rallied significantly in the days leading up to and immediately following President Trump's inauguration. The month closed on a sour note, partly due to Chinese artificial intelligence (AI) threats and trade war rhetoric.

Equity markets are optimistic about the new administration's pro-business agenda, but Donald Trump got off to a breakneck start. It appears the president is setting out to accomplish everything he promised to do.

AI and other related advancements have bolstered capital investment in technology across a number of industries. Many equity analysts have found it difficult to model the seemingly insatiable appetite for AI related hardware. Chinese AI chatbot Deepseek put some cold water on the fire when they launched their highly accurate app developed with a budget a fraction of the size of rivals. This caused a significant dislocation in companies most affiliated with AI and data centers as markets recalibrated AI spending expectations.

Tariffs and retaliatory tariffs also contributed to the uncertainty at the close of the month. President Trump utilized tariffs during his first term and he campaigned on the idea he would continue to use them to apply leverage against countries for various reasons. Many have questioned whether these widespread tariffs are a bargaining chip or a bluff, but equity investors are beginning to factor a higher likelihood of implementation. Tariffs and retaliatory tariffs run the risk of slowing earnings growth for multinational companies and pressuring consumers with higher inflation.

January may very well be a good barometer for what we can expect in the rest of 2025. There are a number of encouraging factors for equity investors, but there is also a significant level of uncertainty which should make for a volatile year.

Positives

Consumer, labor markets and other economic factors remain favorable

AI and other technological advancements

Negatives

Elevated trade war risk

Widespread geopolitical tensions

Lofty equity valuations

Unknowns

The Federal Reserve - the pace of future rate cuts

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FIXED INCOME OUTLOOK

Summary

Following a painful quarter, January provided a much-needed respite for bond investors. Despite some intra-month volatility, treasury bond yields ended the month little changed from starting levels. Continuing December's trend, yields popped even higher for a few days following the release of a strong December payroll report, but then dropped back down with favorable inflation data and some easing of tariff concerns. The 10-year ended January 3 basis points (bps) lower at a yield of 4.54%. The 2-year Treasury note followed a similar pattern with yields rising 14 bps before declining to end the month 4 bps lower at 4.20%. For the month, intermediate-maturity treasury notes delivered a return of 0.54%.

Issuance of new investment-grade corporate bonds was very active in January at $188 billion. This level was about 25% higher than the average of the previous four Januarys and the eighth-highest monthly issuance ever according to JP Morgan research. Despite heavy supply, corporate bond spreads have been in relatively narrow trading range since early November and closed January a few bps tighter for the month. Intermediate-maturity corporate bonds returned 0.62%, again outpacing treasury debt. The Bloomberg Intermediate Government/Credit Index delivered a return of 0.57%, which is almost exactly the index's median return since its inception in 1976.

At the late January meeting of the Federal Reserve's Open Market Committee (FOMC), the Fed decided to hold the overnight rate steady at a range of 4.25% to 4.50%. No change was anticipated after three consecutive rate cuts. It is now widely expected the Fed will be on hold until sometime mid year. Anticipating stronger economic growth, most forecasters now look for only one or two rate cuts for the year. The Fed Funds futures market aligns with this outlook. Our outlook also sees at most two rate cuts this year and one or two additional in 2026. With most in agreement, we still believe there is an opportunity for yields to decline from current levels. The 2-year treasury note appears to be priced for only one rate cut this year (June) and then not again until June 2026. Should there be slowing in the labor market or returning progress toward the Fed's 2% inflation target and investors begin to fully expect two cuts this year and at least two more in 2026, then the 2-year yield could decline to 4% or below. That move would likely pull longer rates lower as well.

We are maintaining our neutral or full-duration exposure. Even without an acceleration in rate cuts we find yields attractive at current levels and see little risk of rates spiking back to cycle highs. Bond investors should be rewarded with at least the current yield and the potential for higher returns as bonds age toward maturity. With credit spreads at historically tight levels, we also still view corporate bonds as attractive given the solid economic backdrop and little risk of recession. We continue to recommend an overweight to high-quality, investment-grade corporate bonds.

Positives

Yields still elevated following the first Fed rate cut last September

Positive slope to the yield curve allows bonds to appreciate as they age

Only one or two rate cuts are expected this year and 2026, could be more

Negatives

Faster economic growth could pressure labor market

Tariffs could disrupt trade and elevate inflationary pressures

Potential for larger federal budget deficits especially with tax cuts

Unknowns

Ability to end Israeli conflict and Russia/Ukraine war

Tax policies, budget reconciliation and ability of DOGE to cut spending