Osprey
PRIVATE WEALTH

January 2025 Commentary

As we end 2024, we think it is a good time for "Peaceful Reflection" both on a personal level as well as on an economic and market level. This year certainly has had its challenges and yet there are many things to be thankful for including a stock market, as measured by the S&P 500, which is up by over 20% for the second year in a row!

Inflation

We entered 2024 with the expectation from the Fed that inflation as measured by the Personal Consumption Expenditures Index (PCE) would substantially decline towards their stated goal of 2%[2], that the economy would slow and that we could potentially see six rate cuts beginning in the first quarter.

Although inflation did indeed continue to work its way down towards the Fed's target level, we have yet to attain the 2% goal. Inflation proved a bit more stubborn than the Fed had hoped for, particularly in the Services and Home Prices segments. This delayed the initiation of rate cuts until the end of the third quarter and reduced the number of cuts for the year down to three.

U.S. Personal Consumption Expenditures (PCE)

Source: FactSet

As shown above, the recently released November reading of the PCE came in at 2.44%. At the Fed's FOMC meeting on December 18th, Chairman Powell significantly altered expectations for further rate reductions for next year from four to perhaps only two[3]. The S&P 500, which is currently trading at a somewhat lofty valuation of 22 x 2025 Earnings Per Share[4], reacted poorly and dropped approximately 3% on the day. This reflected the market's concern about the future rate of inflation and the diminished prospect of lower interest rates in the year ahead.

The potential resurgence of inflation, potentially exacerbated by tariffs, is our biggest concern for the year ahead.

Taxes

Another significant topic for 2025 will revolve around the future of taxes. Several provisions from the Tax Cuts and Jobs Act of 2017 are set to expire at the end of 2025 unless Congress can muster a majority to enact a replacement bill. The 2017 law included lower tax brackets, a higher standard deduction and a boost to the child tax credit.

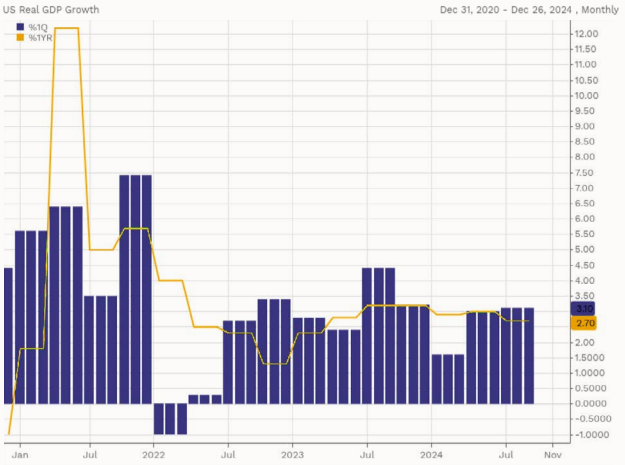
Additionally, failure to pass a new tax act could have a significant impact on income and capital gains tax rates as well as a lower exemption threshold from estate taxes. Other possible tax considerations revolve around service worker tips, social security and the level of deductibility of state and local taxes (known as SALT). There is little margin for error as the Republicans' control of both the House and Senate is slim.

Economy

The fear at the end of last year was that the Fed had raised rates too much and too quickly and that this would lead the U.S. into a recession. Fortunately, this fear turned out to be overblown.

Although the U.S. economy has slowed down a bit, it is still expected to report growth of roughly 3% for 2024[5]. This is a relatively strong growth rate when compared to the European Union which is expected to report roughly 1% growth for 2024 and China which continues to confront a post pandemic economic slump and is expected to report an anemic (for them) growth rate for 2024 of approximately 4.9%.

U.S. Real GDP Growth



Source: FactSet

As would be expected with higher interest rates, we have seen a modest increase in the U.S. unemployment rate during 2024 from 3.7% to 4.2%, but this is still considered a "healthy" level of unemployment.

Although we anticipate that the U.S. economy will slow further in the first half of 2025, we are cautiously optimistic that a recession will be avoided with the Fed's help. One curveball that could disrupt this "soft landing" expectation is the prospect of tariffs.

The incoming Trump administration has threatened the broad use of tariffs against many countries simultaneously. This heavy-handed approach to trade is a gamble that targeted countries will fear loss of easy access to the largest economy in the world and will be quick to make concessions. The risk for the U.S. is that if these tariffs remain in place over a lengthy period of time, it will lead to a resurgence in inflation which will in turn force the Fed to stop lowering rates or even raise them.

AI and Quantum Computing

Throughout 2024 there has been much hype and an immense amount of investment in AI by most of the Magnificent Seven companies as they race to build out their machine learning capabilities to compete in this new frontier. This has benefitted several chip companies, but none more than Nvidia, which saw its stock rise over 175% in 2024[6] to become the second largest S&P 500 company by market capitalization just behind Apple.

Nvidia 1 Year Performance Chart

Source: FactSet

This arms race to amass the most computing power in order to build large language models that are able to utilize machine learning and even inference is likely to continue for years.

Another technological innovation that is now beginning to come into focus is quantum computing. Over the coming years, this promises to become another disruptor to the status quo that will have a far-reaching impact on many facets of our lives.

A recent example of quantum computing's power was the announcement by Google of their new Willow chip. Willow's speed is almost incomprehensible and according to Google can perform a computation in under five minutes that would take one of today's fastest supercomputers 10 septillion years to solve![7]

This technology along with AI will lead to a new wave of innovation across the healthcare, financial and industrial sectors that will drastically change our world both for the better and potentially the worse. On the positive side, these technologies will likely dramatically improve our productivity, which will in turn help our economy grow faster and add downward pressure on inflation.

Today, these revolutionary technologies are still in their infancy, and we will see waves of success and retrenchment along the way. Two impediments that will have to be overcome in order for this future to play out are the incredible amount of necessary continuous investment and the limitations of our ability to produce and transport the insatiable amount of energy that is required.

We intend to pay close attention to developments in these areas as we believe they offer a great deal of long-term opportunity.

2025 Outlook

As we peer into next year, we expect the Fed will remain "data dependent," continuing to monitor the economy for changes in inflation, GDP and the unemployment rate. Fortunately, with the current Fed Funds target rate now between 4.25-4.5%[8] they have the flexibility to cut rates more aggressively if necessary. Therefore, it is our expectation that although the economy will likely slow further in 2025, we do not currently anticipate a recession.

We are mindful of the fact that the S&P 500 has just completed two great years in a row and now trades at an elevated valuation of approximately 22 x 2025 estimated earnings[9]. We are also mindful that investors are anticipating a more business friendly atmosphere in the upcoming year with the hope for lower corporate tax rates and less regulation. Even if these expectations are met, some of this optimism has already been priced into the market. There is the possibility that we could be experiencing "Peak Trump" as he may encounter unforeseen challenges in executing his agenda especially with the narrow margin the Republicans hold in both the House and Senate.

Given the strong market performance of the last two years, we would not be surprised to see a mild correction early in the year and higher volatility in general throughout the year. Despite these concerns, the economy and corporate earnings are likely to continue to grow modestly and this gives us hope that the U.S. market can produce a third year in a row of gains.

Finally, in this season of gratitude, we would like to thank all of our clients, professional advisors and vendors for their ongoing trust and loyalty as we continue to build Osprey to meet our vision of excellence.

Thank you and Happy New Year!

~ The Team at Osprey

Sources:

[1] Barron's
[2] Federal Reserve Chairman Jerome Powell
[3] Jerome Powell, FOMC Meeting press conference on December 18, 2024
[4] Goldman Sachs
[5] Federal Reserve Bank of St. Louis
[6] FactSet
[7] Google press release December 9, 2024
[8] Federal Reserve Bank of St. Louis
[9] Goldman Sachs