

Introduction

The year 2025 is poised to be a pivotal one, marked by significant economic, political, and social developments. From the policies of the Trump administration, including tariffs, taxes, and immigration, to the Federal Reserve's monetary policy dynamics, we will explore the potential impacts on the economy and financial markets. Additionally, we will examine the ongoing struggles within the Chinese economy, the state of US equities, and the broader implications of these factors on global trade and investment.

In this report, our goal is to equip readers with an understanding of the challenges and opportunities that lie ahead, helping to enable them to make informed decisions in an increasingly complex and interconnected world. By examining the interplay between domestic policies and international developments, we hope to shed light on the forces driving change and the potential outcomes for various stakeholders.

GLOBAL MACROECONOMIC INVESTMENT COMMITTEE

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Key takeaways

- **Trump Administration Policies:** The policies of the Trump administration, including tariffs, taxes, and immigration reforms, will significantly impact the US economy. These policies could lead to inflationary pressures, changes in trade dynamics, and shifts in the labor market.
- **Federal Reserve Policy Dynamics:** The Federal Reserve faces a challenging year in 2025, dealing with the need to balance growth with inflation that is persistently higher than desired. The Fed's decisions on monetary policy will be crucial in shaping the economic landscape.
- **China's Economic Struggles:** The Chinese economy continues to face challenges, including deflationary pressures, a troubled real estate sector, and geopolitical tensions. These issues could have significant implications for global trade and investment.
- **US Equities:** The US stock market remains a focal point, with concerns about elevated valuations and concentration risk. The performance of a few large cap stocks has driven much of the market's gains over the past two years, raising questions about diversification and market vulnerability.

Trump administration policies: tariffs, taxes, and immigration

Trump made numerous promises while on the campaign trail. However, the market's current focus is on which of these promises ultimately get implemented into policy. Given that Republicans control both the House and the Senate, it is expected that some of Trump's policies could be implemented within the first 12-18 months of his administration. In broad terms, we know that key initiatives may include tariffs, tax cuts, and changes to immigration policy.

President Trump's campaign speeches included frequent calls for protective tariffs on imports from trading partners including China, Mexico, Canada, and the European Union, among others. Since the inception of the Trump tariffs on China in 2018, imports from Mexico and Europe have continued to rise while imports from China have declined so that they are no longer our largest trade partner¹ (see Figure 1). These tariffs could serve multiple purposes, such as helping protect US industries from foreign competition and providing additional income to the federal government. However, there is still a great deal of uncertainty about the timing, degree, and scope of tariffs, not to mention how other countries may choose to retaliate.²

¹ Source: FRED customs data as of December 2024.

² Source: CSIS, D. Nelson, "Trump Trade 2.0," December 20, 2024.

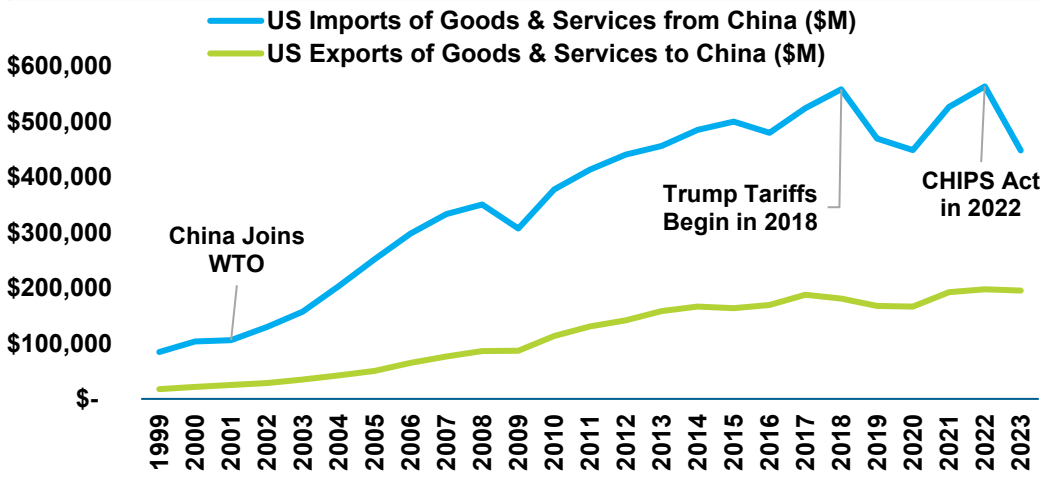


FIGURE 1
US & China Trade in Goods & Services 1999-2023 (USD \$M)

Source: Bureau of Economic Analysis national accounts data as of December 2023.

However, higher tariffs may lead to domestic inflationary pressures if they push up the prices of imported goods.³ The extent of the inflationary pressure would likely depend on how broad the tariffs are, how high they are, and how long they are in place. At this time, we cannot know the scope and scale of Trump’s trade policies. However, looking back to his prior presidency, the impact of tariffs initiated then and expanded upon by President Biden had a short-term impact on producer prices in 2017 and 2018 but little inflationary impact over the medium term.⁴ It is possible that companies and countries will take actions (e.g., shifting where they produce goods or export final goods from) that could blunt some of the potential inflationary impact of tariffs⁵ (see Figure 2).

³ Source: Federal Reserve Board, A. Flaaten et al., “Disentangling the Effects of the 2018-2019 Tariffs on a Globally Connected US Manufacturing Sector,” December 2019.

⁴ Source: FRED as of December 2024. Headline inflation in the US was 2.85% in July of 2018 with Trump tariffs taking effect in the second half of 2018. By July of 2019, headline inflation as measured by CPI fell to 1.82%. US companies with exposure to China and the Trump tariffs cited higher input costs in the fall of 2018. In 2017 and 2018, the producer price index in the US remained elevated between 4% and 5% but turned negative by July 2019 (-1.9%). In 2018, steel and aluminum tariffs on Chinese imports reached peak trade tensions and price effects. In May 2019, the US lifted tariffs on steel and aluminum imports from Mexico and Canada. See PIIE “Trump’s Trade War Timeline: An Up-to-Date Guide,” December 2023.

⁵ Source: Bloomberg, “Here’s How \$260 B in Tariffs Are Biting Third Quarter Profits,” October 23, 2018.

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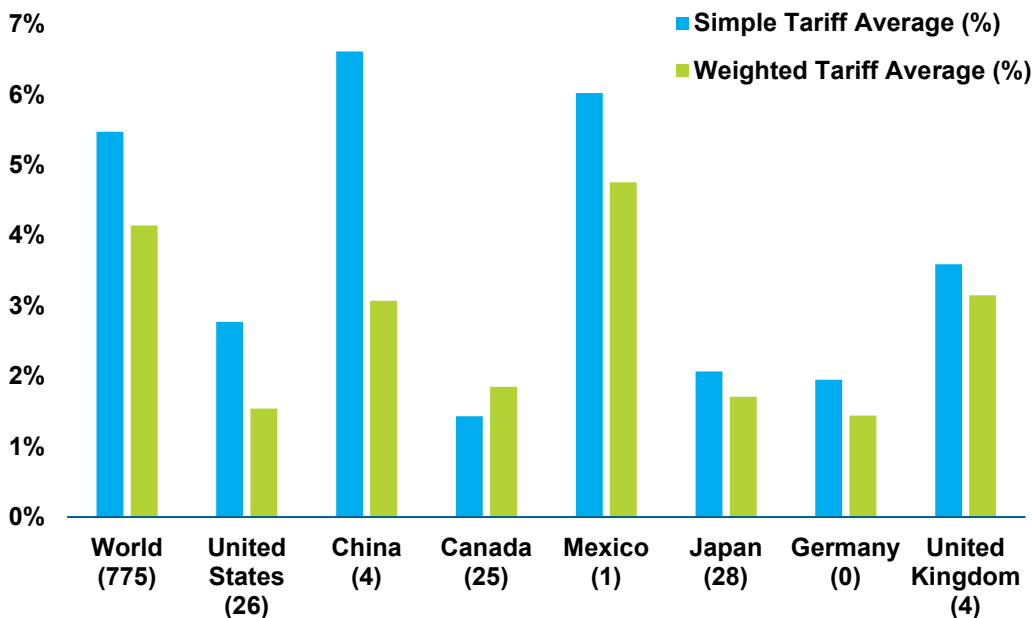


FIGURE 2
Global Average Tariffs (%)

Source: World Integrated Trade Solution as of December 2024. Annual trade data presented in 2024 includes data from 2022 and 2023. Number of trade agreements shown in parentheses. Tariffs are typically assessed on the market value of the imports as a percentage of that value. A simple average tariff rate is the average of tariffs. Weighted tariff average reflects the volume weighted applied tariff on imports. Where for example a high tariff on a small volume of imports would have a lower impact on the total tariff burden on imports. Assessing trade openness in a wholistic manner may also include non-tariff measures such as government subsidies and regulatory and statutory prohibitions on non-domestic business activities. Trade in services may also face barriers or impediments not captured in import tariff statistics.

President Trump also promised further tax cuts for corporations and individuals. However, with the US debt-to-GDP ratio at its highest level since the end of WWII, slashing government revenues at a time when debt servicing costs are nearing three percent of GDP could have far-reaching consequences for Treasury yields as it may diminish investor appetite for US debt. While the Trump administration hopes to reduce some spending via the Department of Government Efficiency (“DOGE”), critics argue that this will be insufficient to off-set the decline in tax revenues (see Figure 3).

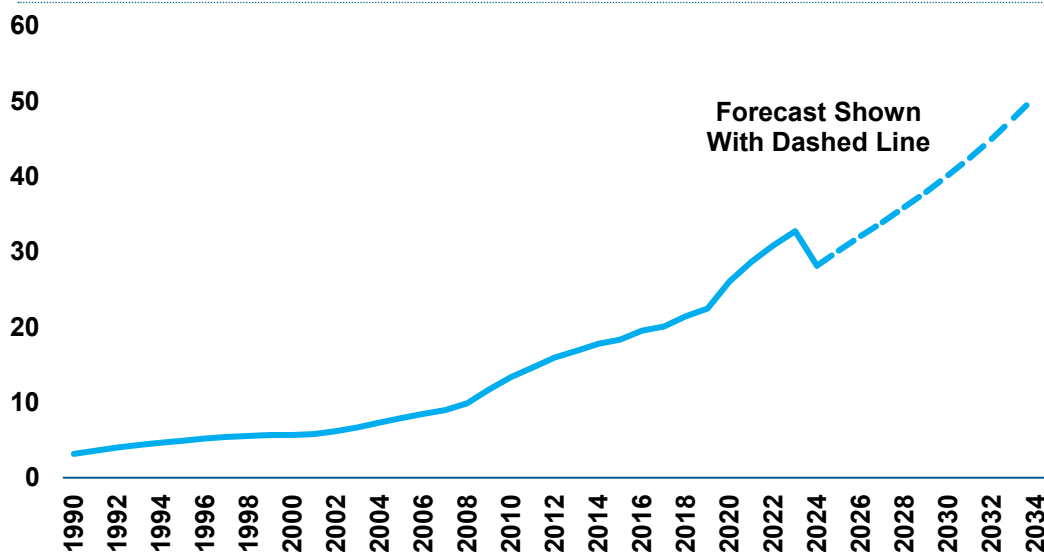


FIGURE 3
US Government Debt 1990-2034 (USD T)

Source: FRED as of December 23, 2024. Includes Congressional Budget Office Forecast as of June 2024.

Stricter immigration policies, including deportations, could reduce the labor force, leading to wage inflation as companies are potentially forced to compete for a smaller pool of laborers. With approximately four million baby-boomers retiring each year through the next decade, the US may find it has too few young workers to fill the job vacancies.

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⁶ Source: Brookings, W. Frey, “New Census Projections Show Immigration is Essential to the Growth and Vitality of a More Diverse US Population,” November 29, 2024.

⁷ Source: Ibid.

⁸ Source: Ibid. See also Brookings, W. Frey, “New 2020 Census Data Shows and Aging America and Wider Racial Gaps Between Generations,” August 1, 2023.

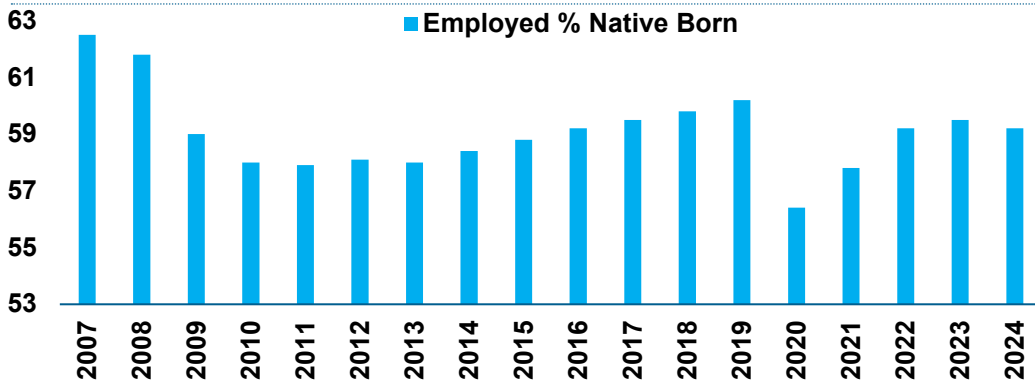


FIGURE 4
Percent of US Workforce Who Are Native Born

Source: FRED as of November 2024. Between 2007 and November 2024 the number of employed workers rose from 137.6 million to 159.3 million.

Federal Reserve policy dynamics

The Federal Reserve faces a critical year in 2025, navigating an economic environment influenced by inflation levels still above its target level and uncertainties surrounding the Trump administration’s pro-growth agenda. Moreover, the Federal Reserve may have underestimated the persistent inflationary pressures in the US economy as the FOMC substantially increased their inflation outlook for 2025 in the most recent summary of economic projections⁹ (see Figure 5).

⁹ Source: Federal Reserve Summary of Economic Projections for September and December 2024. In September 2024, the FOMC forecast that PCE inflation in 2025 would range between 2.1 and 2.2 percent with the Fed Funds Rate between 3.1% and 3.6%. But by December this year, the FOMC increased their 2025 Fed Funds Rate forecast to 3.6% to 4.1% and PCE inflation to 2.5% to 2.7%.

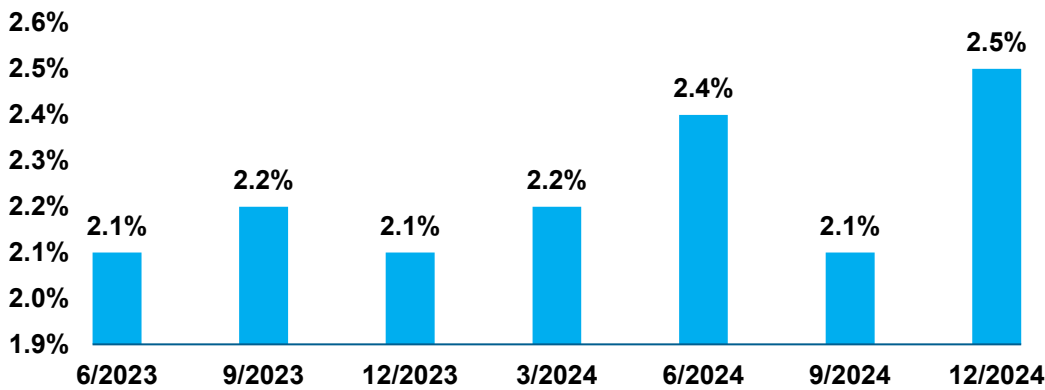


FIGURE 5
FOMC Projections for 2025 Median Core PCE Inflation (%)

Source: FRED as of December 18, 2024. FOMC Summary of Economic Projections (“SEP”), released quarterly, includes annual forecasts for the estimated median Fed Funds Rate and Personal Consumption Expenditure (“PCE”) (unadjusted). These projections reflect the median forecast of voting members of the FOMC.

Inflationary pressures have driven borrowing costs higher, especially for the US government whose annual interest expense exceeded one-trillion dollars in 2024 (see Figure 6). For perspective, in 2021 the US government’s debt servicing costs were \$574 billion dollars. In November 2024, those debt servicing costs had doubled to \$1.1 trillion dollars.¹⁰

¹⁰ Source: FRED as of December 2024.

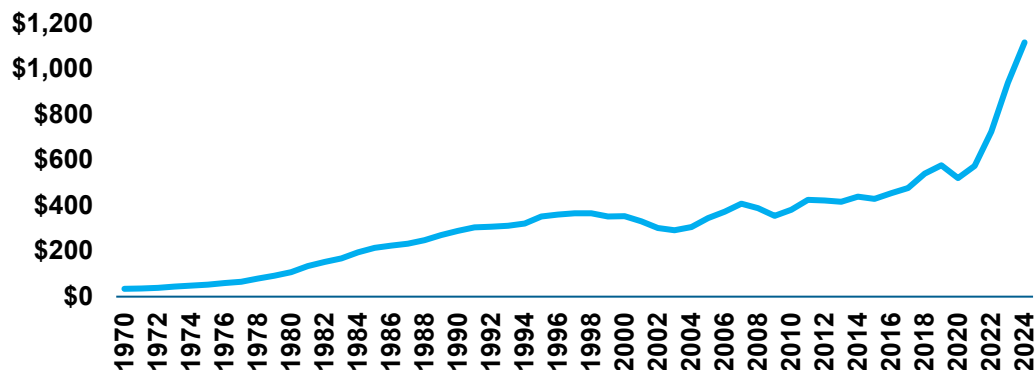


FIGURE 6
US Government Annual Debt Service Payments (USD B) 1970–2024

Source: FRED as of December 2024.

Inflation in the US has been frustratingly stubborn and the base effects which helped cool headline inflation are now behind us.¹¹ With better-than-expected economic growth and labor markets, along with the risk of increased inflationary pressures from Trump's policies, the justification to cut interest rates in the year ahead may prove elusive.

¹¹ Source: The Federal Reserve, December 18, 2025. See also The Financial Times, R. Armstrong, "Trump and the Fed: Battlelines," December 18, 2024.

In 2024, the Fed's messaging swayed from hawkish in July, to dovish in September with a 0.50% rate cut, and back to what the market perceived as a hawkish rate cut in December. Likewise, in the last few months, both the Fed and the markets have elevated their respective expectations for the Fed Funds Rate in 2025 and 2026 by approximately 100 basis points (see Figure 7). For example, the estimated year-end 2025 Fed Funds Rate could range between 3.1% and 4.4% according to the Summary of Economic Projections' dot plot.¹² The number of rate cuts anticipated by the market through the end of 2025 has fallen from ten at the start of 2024 to just under two at the end of the year.¹³

¹² Source: Federal Reserve Summary of Economic Projections as of December 2024. Financial Times, M. El-Erian, "Federal Reserve's Flip-Flops Risk Undermining US Exceptionalism," December 22, 2024.

¹³ Source: CME Fed Watch Tool as of December 30, 2024.

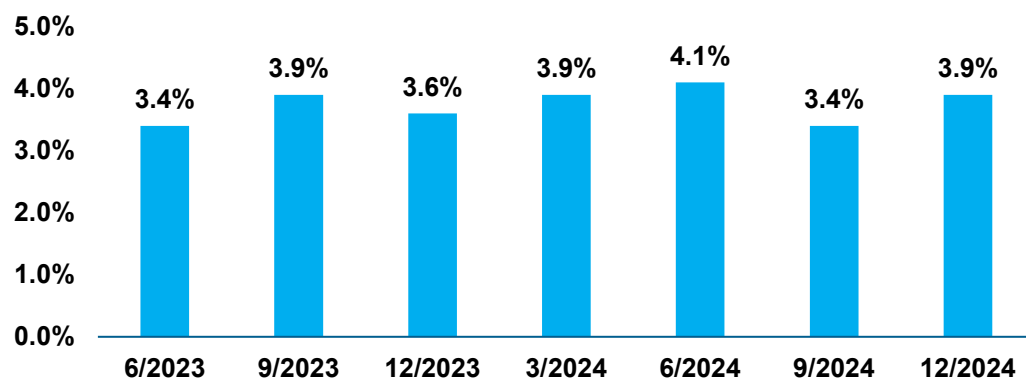


FIGURE 7
FOMC Projections for 2025
Median Fed Funds Rate (%)

Source: FRED as of December 18, 2024. FOMC Summary of Economic Projections ("SEP"), released quarterly, includes annual forecasts for the estimated median Fed Funds Rate and Personal Consumption Expenditure ("PCE") (unadjusted). These projections reflect the median forecast of voting members of the FOMC.

Finally, the terminal rate could remain higher than initial projections, increasing borrowing costs for both businesses and consumers, thereby acting as a headwind on investment and consumption.

Yield curve and credit spreads

Since the Fed commenced its rate hiking cycle in 2022, financial markets have until recently lived with an inverted yield curve as short-term bond yields have remained higher than long-term yields. The inversion has been driven by the Fed's rate hikes influencing the front-end of the yield curve and expectations of growth and inflation falling, impacting longer-term rates.

The dynamics of the yield curve will play an important role throughout 2025 due to the Federal Reserve's evolving monetary policy. A continued steepening of the yield curve could be driven by the Fed cutting interest rates further, although at a slower pace than previously expected. At the same time increased confidence in growth, due to either fiscal stimulus or pro-growth

policies, could drive long-term rates higher. Rising concerns about inflation and a growing budget deficit could also drive longer-term interest rates up. On the other hand, a flattening or inverting curve could reflect a more cautious Fed, skepticism about growth, or heightened concerns about the Fed's ability to tame inflation without triggering a recession.

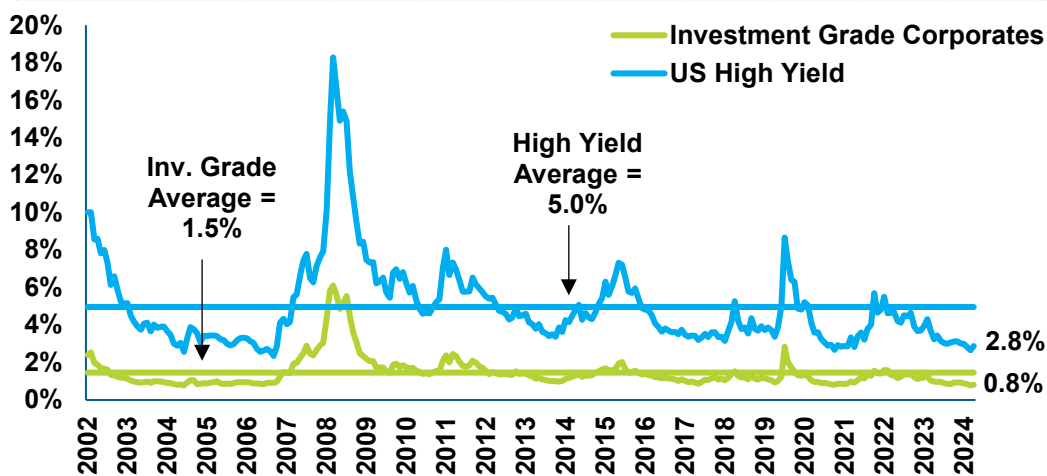


FIGURE 8
Credit Spreads

Source: Bloomberg as of December 2024

Spreads (the added yield above a comparable Treasury) tightened substantially in 2024. (see Figure 8) This has allowed companies, particularly in the high yield space, to borrow at historically narrow premiums to the US government. If spreads remain tight in 2025, it will help facilitate corporate lending and potentially spur economic growth. By contrast, a widening of spreads could slow credit creation and slow growth.

China – Domestic struggles, geopolitics, and trade

Since the outbreak of the COVID pandemic, the Chinese economy has struggled. The IMF cut its 2024 growth estimate to 4.8% and just 4.5% for 2025.¹⁴ Deflationary pressures persist, and sovereign bond yields now trade below Japanese bond yields.¹⁵ The troubled Chinese real estate sector hit local and provincial government revenues hard.

The Chinese Communist Party has taken a cautious ad hoc policy approach by cutting policy rates, expanding new debt issuance allocations for local government, and supporting bank liquidity. While details for local government debt restructuring are still unfolding, the program is thought to encompass approximately two trillion dollars (or 14.3 trillion RmB) in hidden debt (see Figure 9). Ever larger debt issuance allowances have been allocated by the central government to preserve solvency and protect local banks and special investment funds that hold most of these bonds. A stimulus package in late September to support stock prices had some effect, but momentum faded in subsequent months.¹⁶

¹⁴ Source: IMF World Economic Outlook, October 2024.

¹⁵ Source: Bloomberg, B. Penz, "China's Plunging Bond Yields Draw Japan Comparisons," December 13, 2024.

¹⁶ Source: Barron's C. Keown, "The China Stock Rally Is Already Fading. Why Alibaba and JD.Com Stocks Are Falling," December 10, 2024.

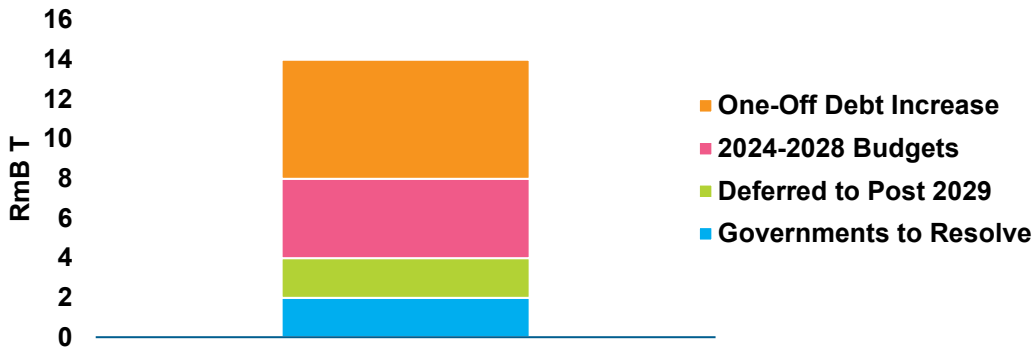


FIGURE 9
Hidden Local Government Debts to Be Restructured (RmB T)

Source: JP Morgan Private Bank, "China Outlook: Can China Make It in 2025?" November 25, 2025. Hidden local government debt estimated dollar value is approximately \$2 Trillion based on current exchange rate.

Until recently, China's manufacturing markets (especially for exports) had been the one bright spot for the economy. However, geopolitical tensions have had a real economic impact in China. Foreign Direct Investment ("FDI") into the country has declined 29.1% on a year over year basis.¹⁷ The potential additional tariffs that could be implemented on Chinese products are expected to have knock-on effects within the economy. Some analysts suggest that a 20% tariff on Chinese products could cut their annual growth by at least 70 basis points.¹⁸

¹⁷ Source: Densan Shira & Associates, G. Interesse, "Decoding China's H1 2024 Foreign Direct Investment, August 9, 2024.

¹⁸ Source: M. Kotecha of Barclays quoted in CNBC TV 18, "China's Biggest Fiscal Stimulus Will Come in 2025," November 19, 2024. Kotecha expects significant fiscal stimulus following March 2025 Chinese Communist Party Meetings.

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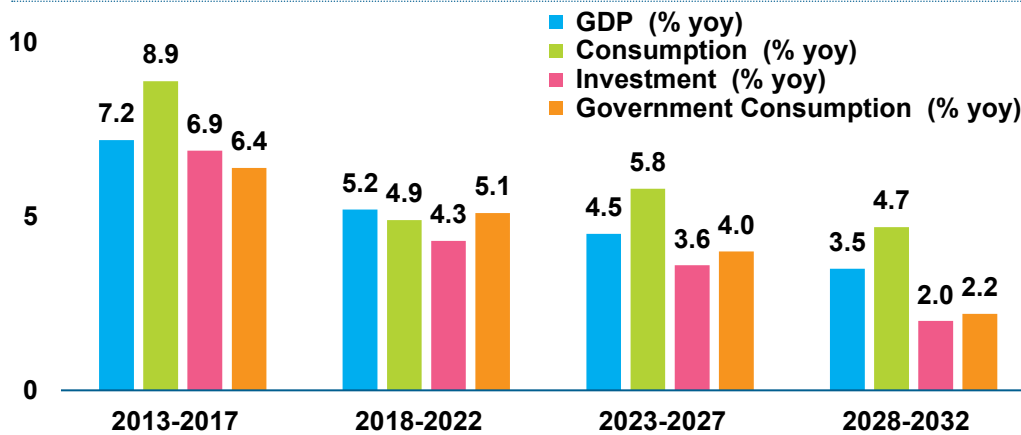


FIGURE 10
China Year-on-Year Growth (%) by Sector (2014-2034)

Source: Oxford Economics as of November 2024. "Policy Support Set to Gear Up Amid Rising Risks," November 2024.

In response to trade tensions and economic pressures, China has allowed the yuan to depreciate versus the dollar, making their exports cheaper. Since the end of September, the yuan has fallen close to 4% compared to the US dollar. However, a weaker currency presents additional risks because if the yuan depreciates too much it could spark capital outflows, significantly raise the price of imports, and increase foreign debt servicing costs. Despite considerable policy efforts to boost economic growth and revive flagging domestic demand, forecasts for China's economy continue to be revised lower (see Figure 10).

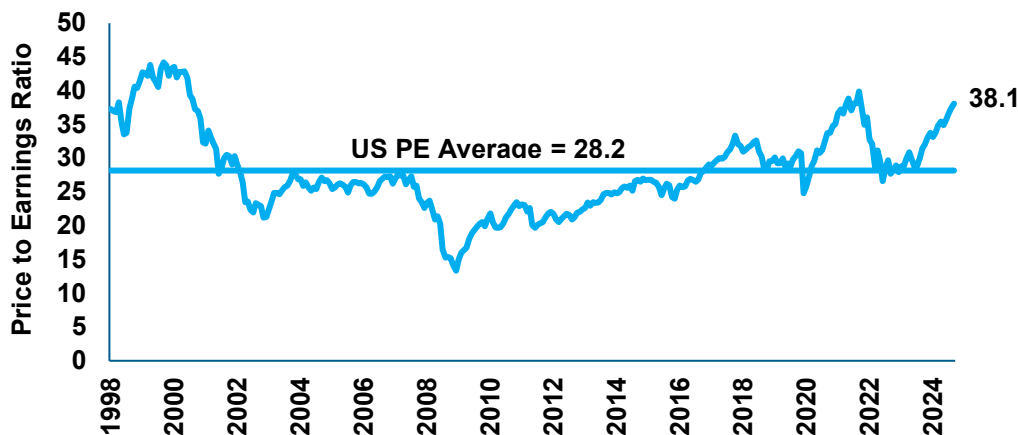
US equities: valuations and concentration

In 2025, US equities remain a key focus, with the two primary themes of 2024 continuing to be important: concentration risk and elevated valuations.¹⁹ Throughout the recent run up, a handful of large cap stocks (“The Magnificent 7”²⁰) within the technology and consumer discretionary sectors drove much of the gains. The Magnificent 7 accounted for 53.9% of the S&P 500 returns in 2024 and over 57% over the past three years.²¹ The Magnificent 7’s share of market capitalization of the S&P 500 grew from 27% in December 2021 to 33.8% at the end of 2024.²² This resulted in an elevated level of concentration, where the performance of these companies disproportionately impacted the overall returns of investors. Questions remain though about whether these technology and AI related stocks can continue to drive earnings growth in 2025.

This raises concerns about diversification, as any weakness in these stocks could have outsized effects on portfolio performance. However, the breadth of stock market gains has increased following the election of President Trump as sectors linked to his pro-growth policies, such as consumer discretionary, communication services, and consumer staples have exhibited the strongest recent performance. We will continue to monitor whether this trend persists as a broader rally in equities could pose less of a risk.

Valuations remain elevated, with price-to-earnings ratios well above historic averages.

Valuations remain elevated, with price-to-earnings ratios well above historic averages (see Figure 12). The elevated level of valuations for US equities reflect optimism about continued earnings growth and economic resilience, as well as a bet on the continued investment in and likely (future) benefits from AI. However, these lofty valuations increase the market’s vulnerability to macroeconomic shocks and earnings disappointments. In addition, the Federal Reserve’s policy decisions, inflation, and consumer demand will be critical factors to watch, as they could help the market sustain current valuations or trigger a broader market sell-off.



¹⁹ Source: <https://meketa.com/leadership/the-magnificent-seven/>

²⁰ Source: The “Magnificent 7” stocks consist of Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla.

²¹ Source: FactSet as of December 2024.

²² Source: FactSet as of December 2024. The top 10 stocks in the S&P 500 account for over 37% of the market capitalization.

FIGURE 11
Cyclically Adjusted Price/
Earnings Ratios

Source: Bloomberg as of December 2024.

Conclusion

In conclusion, the year 2025 presents a complex and dynamic landscape shaped by significant economic, political, and social developments. The policies of the Trump administration, including tariffs, taxes, and immigration reforms, will play a crucial role in determining the trajectory of the US economy. The Federal Reserve's monetary policy decisions will also be pivotal, as they navigate persistent inflationary pressures and the challenges of balancing growth with financial stability. The interplay between these domestic policies and international developments, such as the ongoing struggles within the Chinese economy and the state of US equities, will have far-reaching implications for global trade and investment.

As we move forward, it is essential to monitor these key trends and events to help understand their potential impact on various stakeholders. By staying informed and adaptable, businesses and investors can better navigate the uncertainties and opportunities that lie ahead. The year 2025 will undoubtedly be a pivotal one, and understanding the forces driving change will be crucial for success.

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