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2025 Outlook

A New Technological Revolution Takes Shape

Executive Summary

In 2024, economic resilience and artificial intelligence (AI)-driven growth fueled a massive 25% gain in the S&P 500, driven again by mega-cap technology stocks.

The Federal Reserve started to cut rates but discussed a measured pace of future rate cuts, navigating between reducing inflation and supporting growth.

The surprising Republican sweep administration adds some uncertainty, with potentially inflationary fiscal policies counterbalanced by hopes for economic growth and efficiency gains.

Looking ahead to 2025, the global economy is expected to moderate, with U.S. GDP projected to grow at 2.0–2.5%. While consumer spending and infrastructure investments continue to support economic stability, headwinds such as housing affordability and geopolitical risks persist.

AI remains a central theme, driving productivity across sectors, from healthcare and energy to logistics.

In financial markets, 2025 could mark the long-awaited transition from U.S. mega-cap tech dominance to broader market participation, with many sectors and asset classes outside of tech having the potential to gain traction including smaller cap stocks.

Foreign stocks may be aided by structural reforms and relative valuation attractiveness. We believe that investors should remember the importance of flexibility and proactive risk management, as technological innovation and economic uncertainty define the year ahead.

Challenges for fixed income due to persistent inflation could linger, potentially making commodities and dividend paying stocks an attractive alternative. Credit opportunities could continue to perform well if the economy is able to avoid a more substantial slowdown.

Potential Positive Drivers	Potential Risks
Resiliency: Strength in consumers and labor market, optimism, potential tax cuts	**Inflation:** Pro-growth policies, increased deficit spending, tariffs lead to resurgence in inflation and rates higher for longer
Productivity: Artificial intelligence, automation, efficiency gains and profitability growth	**Lag in Rewards from AI Spending:** Artificial intelligence hype may not translate to meaningful effects for a few more years
Price: Many parts of the market reasonably priced, such as high quality small- and mid-cap, foreign companies, dividends	**Volatility:** Valuations of large cap tech stocks near all-time expensive levels, elevated uncertainty with new administration

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2024 Summary

We began 2024 optimistic that the economy and markets would avoid recession on the strength of the US labor market, compelling starting valuations for stocks, and the potential for increased productivity gains. We titled our 2024 Outlook, "Finally Normal", because it was the first year since the pandemic where things felt close to in balance again (economy standing on its own two feet, interest rates and inflation moderating, stocks reasonably priced). Growth expectations for large technology companies, particularly those associated with artificial intelligence, were a powerful positive force for markets last year. The S&P 500 led the major indices, generating a return of 25%, while other areas such as small cap stocks, foreign stocks, and bonds advanced but gained only 11%, 4% and 1%, respectively.

We had expected 2024 to provide broader participation outside of large technology stocks but this did not transpire in part due to longer-term interest rates increasing, primarily the result of a stronger economy and future growth outlook. The surprise Republican sweep in Washington has led to renewed concerns regarding inflation and the potential for higher-for-longer interest rates in 2025. This impacted interest rate sensitive areas such as small cap stocks and bonds, which declined 8% and 2% in December, respectively.

Because interest rates and inflation were such a dominant factor in 2024, we open the 2025 Outlook with an update here, as this remains a key risk for markets in 2025.

Recap and Outlook for Interest Rates & Inflation

The Federal Reserve (the Fed) is responsible for keeping the economy balanced. Its main goals are to control rising prices (inflation) while maintaining a stable jobs market. To do this, the Fed adjusts short-term interest rates, which are linked to the cost of borrowing money, to either slow down or boost the economy. It is a delicate balancing act; an overheated economy leads to more inflation, but an overly restrictive Fed could throw the economy into a recession. 2024 was a significant pivot year for the Fed following the most aggressive pace of rate hikes in modern history.

While expectations swung wildly throughout the year, the market was generally optimistic that rate cuts were on the way, providing a strong tailwind for risk assets. Looking back, rate cuts did begin in 2024, but at a slower pace than expected and in three distinct phases.

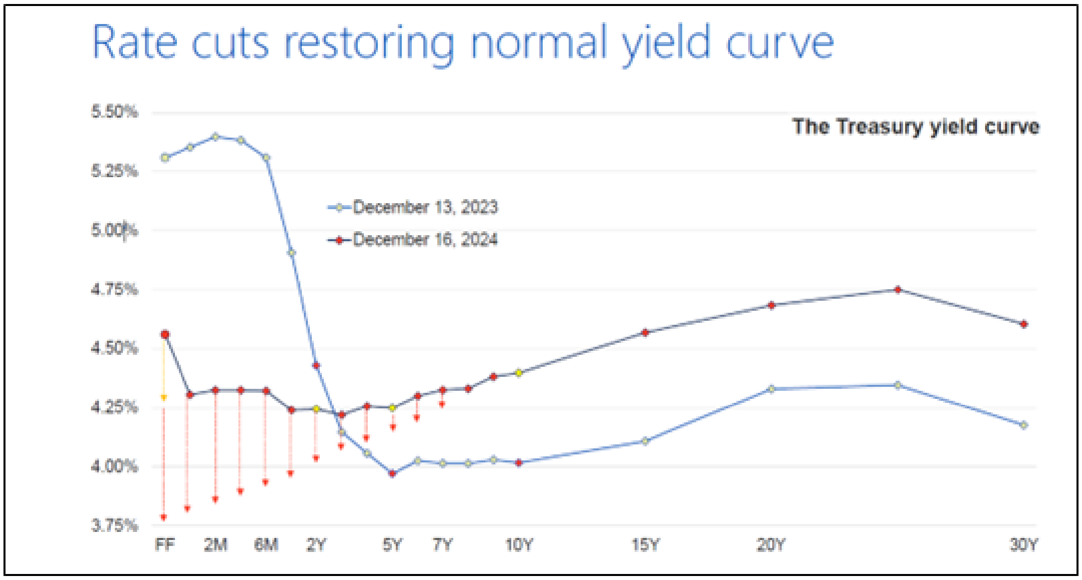


Chart source: Bloomberg, FHN Financial

Phase 1: Peak Restrictive Policy (January-July 2024)

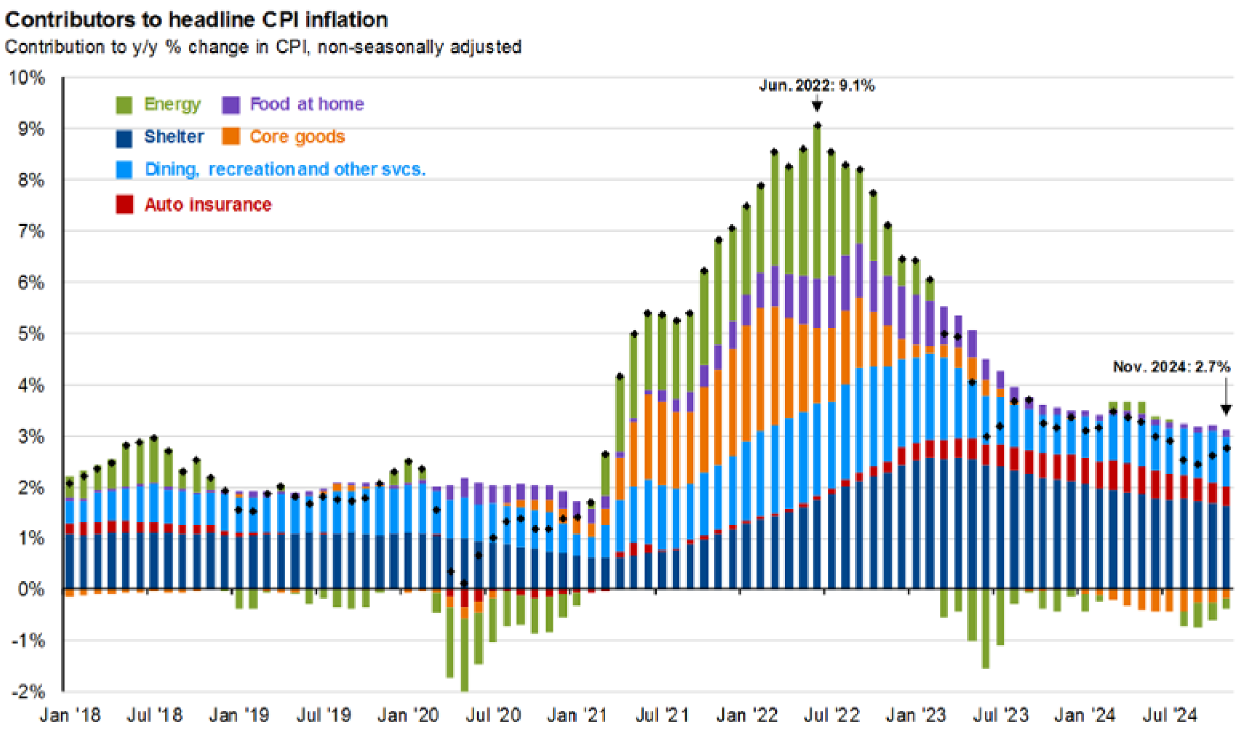
As we entered 2024, the Fed's focus was squarely on bringing down inflation, with the Fed funds target rate at the highest, most restrictive point of this cycle. The economy remained surprisingly resilient during this period, defying many economists and market predicters who were calling for a recession in 2024 as the inevitable result of higher rates. Driven by surprising strength in consumer spending, the US economy grew for most of the year at an annualized rate of close to 3% (nowhere near a recession), and the unemployment rate ticked up only modestly to 4% (still very low by historical standards) by June.[1]

Phase 2: Policy Recalibration (August-October 2024)

Encouraged by progress on inflation and with an eye on the cooling jobs market, the Fed shifted into the second phase of policy for 2024 – Chair Powell referred to it as a "recalibration". After holding short-term rates steady for more than a year, the Fed reduced the target Fed funds rate by 0.50% at the September meeting. This shift and the messaging surrounding it spurred tremendous optimism in the market. The Fed was essentially signaling that we were on our way to the elusive "soft landing", the ideal outcome of monetary policy that has rarely been achieved: economic growth was solid, the labor market was still strong, and inflation was moving sustainably towards its 2% target. Stocks marched higher, and bond yields moved lower during this phase in anticipation of additional rate cuts.

Phase 3: Wait and See / Higher for Longer (November-December 2024)

The initial rate reduction in September was followed by two 0.25% cuts in November and December, for a total of 1.00% of easing in 2024. Closing out the year, the Fed started to shift its tone once again, dampening the markets' optimism of rate cuts to come. The economy is still doing well and progress on inflation is stalling. The primary inflation readings monitored by the market have been moving sideways for the last several months around 2.7% year-over-year, while the Fed would like to see it continue trending lower towards 2%.[2]



Source: BLS, FactSet, J.P. Morgan Asset Management. Contributions mirror the BLS methodology on Table 7 of the CPI report (Table 7. Consumer Price Index for All Urban Consumers (CPI-U): U.S. city average, by expenditure category, 12-month analysis table - 2023 M10 Results (bls.gov)). Values may not sum to headline CPI figures due to rounding and underlying calculations. "Shelter" includes owners' equivalent rent, rent of primary residence and home insurance. *Guide to the Markets – U.S.* Data are as of December 31, 2024.

Inflation in core services like dining and recreation, along with home and rent prices, have been frustratingly slow to come down. Although there were pockets of encouraging slowing, the bottom line is that inflation progress has stalled over the last few months. Adding to the uncertainty is the upcoming change in administration as President Elect Trump takes office in January. It is far from clear where the President Trump's initial focus will be, but many of the policies proposed during the campaign trail are perceived to be inflationary, including pro-growth and pro-spending policies, tax cuts, tariffs, and a reduction in immigration. The potentially resulting inflation may be offset if the administration is successful in increasing governmental efficiency and reducing costs.

Looking Ahead

While the Fed has now reduced short term interest rates by 1% over the last three months, officials are signaling that the path of reduction will be slower moving forward due to the murky inflation outlook. At the final meeting of the year in mid-December, Chair Powell highlighted the uncertainty ahead using an analogy of walking through a dark room filled with furniture – "you just slow down".[3] The Fed will have to see multiple months of improvement in inflation to feel confident about additional policy easing. Markets expect a couple of additional rate cuts in 2025 as the yield curve continues to normalize, meaning short-term yields could move lower while longer-term yields could remain steady or move slightly higher.[4] Currently, market participants are split between expecting one or two additional 0.25% rate cuts in 2025, which would bring the target Fed funds rate to approximately 4%.[5]

Inflation: The Unwelcome Guest Returns

Several factors point to potentially higher inflation in 2025:

- Tight labor markets and wage pressures
- Potential new tariffs under a second Trump administration
- Rising commodity prices amid stronger global growth
- De-globalization trends increasing supply chain costs

While unlikely to reach the 9% levels seen in 2022, we could see a return of inflation uncomfortably above the Fed's 2% target.

Fixed Income Challenges

Bond investors face headwinds in 2025:

- Continued economic strength in the U.S. keeping short rates higher for longer
- Heavy Treasury issuance pressuring long-term yields
- Term premium likely to remain elevated
- Real yields potentially moving higher

These factors suggest another challenging year for traditional bond allocations, with the Bloomberg Aggregate Bond Index likely to deliver modest returns. For investors, we remain cautious about extending duration (interest rate sensitivity) and continue to view alternative and hedging strategies as attractive supplements to traditional fixed income.

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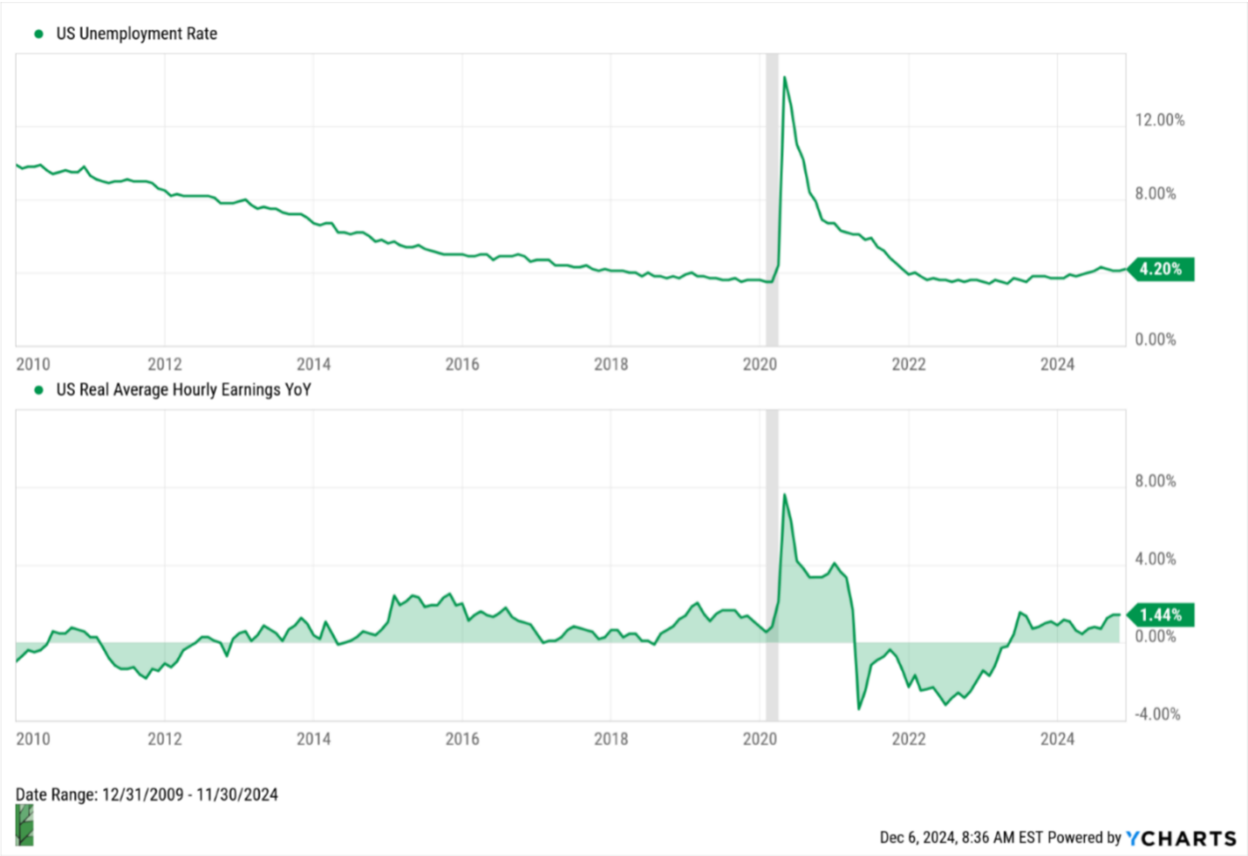
Broader Economic Outlook

The U.S. economy is expected to navigate a delicate balance in 2025, with moderate growth, easing inflation, and a tight labor market shaping the narrative. The U.S. economy expanded at an above-average rate in 2024, driven by resilient consumer spending and robust corporate investment in high-growth sectors artificial intelligence. However, challenges persist, including housing affordability, regional economic disparities, and the potential for global trade disruptions.

The U.S. economy is forecasted to grow by 2.0–2.5% in 2025[6], a slight deceleration from 2024 as the lagging effects of higher interest rates fully take hold. Forecasted growth is primarily supported by steady consumer spending, infrastructure investments, and technological innovation. However, the overall pace reflects normalization after the post-pandemic recovery boom. Global economic trends play a critical role in shaping U.S. growth. According to the International Monetary Fund (IMF), global GDP growth is projected at 3.0% in 2025, also reflecting slower growth in major economies such as China (4.5%) and the Eurozone (1.8%).

Domestically, infrastructure investments under the Infrastructure Investment and Jobs Act (IIJA) and CHIPS Act are expected to contribute 0.3–0.5 percentage points to GDP growth in 2025.[7] Projects focusing on renewable energy, semiconductor manufacturing, and transportation infrastructure will not only support near-term growth but also enhance the economy's long-term productivity.

The U.S. labor market remains a bright spot, with the unemployment rate beginning 2025 at just 4.2%. While job creation slows from the rapid pace of prior years, the economy is expected to add an average of 150,000–200,000 jobs per month[8], focusing on high-demand industries. Real wage growth is expected to remain positive at 1–1.5%, supporting household purchasing power.[9]



The U.S. housing market remains a key area of concern, with affordability challenges persisting. Home prices are forecasted to rise by 2–4%, while mortgage rates remain elevated at 6.5–7%, deterring new buyers.[10] New housing starts are expected to average 1.3 million units, up from 1.2 million in 2024, as builders respond to strong demand for affordable housing. Rental markets remain tight, with vacancy rates below 5% nationally. [11]

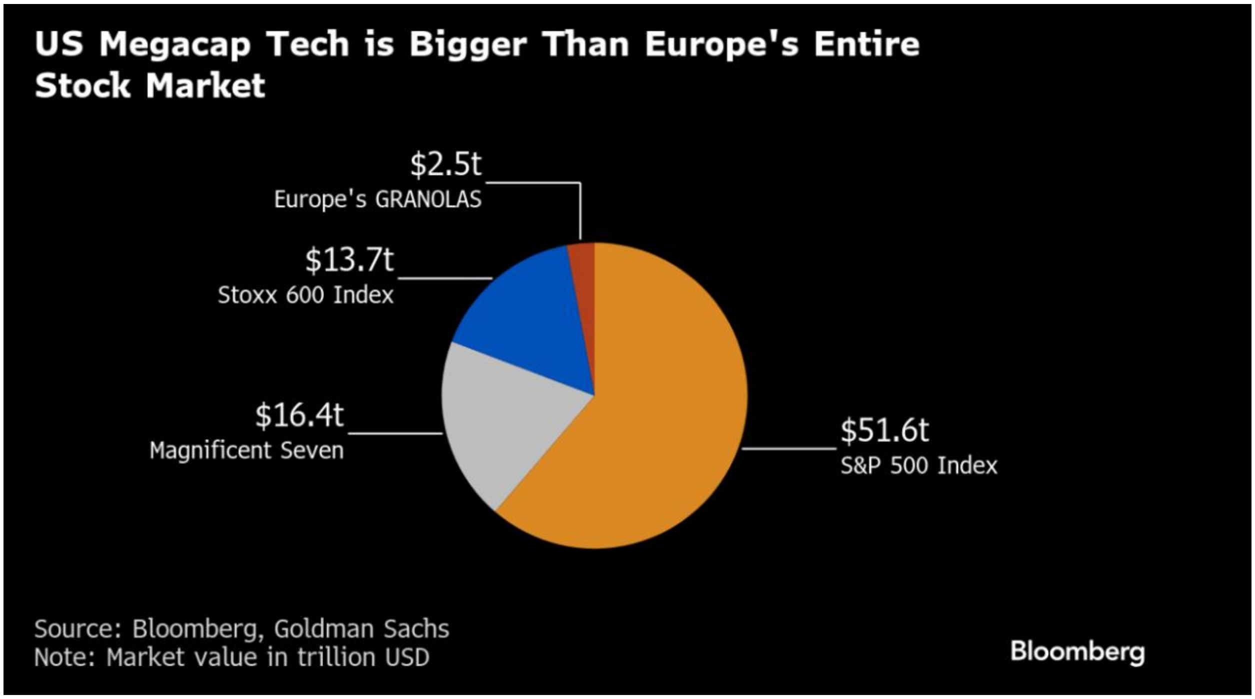
The federal budget deficit is projected to remain elevated at $2 trillion in 2025, driven by rising entitlement spending and interest payments on the national debt. However, targeted investments in infrastructure and clean energy may provide long-term economic benefits. Major infrastructure initiatives under the Infrastructure Investment and Jobs Act will add an estimated $150 billion in direct spending in 2025, supporting construction jobs and potentially boosting productivity.[12]

The U.S. economy in 2025 reflects a story of resilience and adaptability. While challenges persist—ranging from global uncertainties to housing affordability—the combination of steady growth, easing inflation, and robust labor markets positions the economy for sustained progress.

Stock Market Outlook

After the remarkable rally of 2023-2024, driven largely by mega-cap tech stocks and AI enthusiasm, 2025 is shaping up to be a year of transitions and changing market leadership. The dominance of U.S. mega-cap tech has reached extraordinary levels. This has largely been justified by strong revenue and profitability growth, but we believe that at current valuations, the best performing stocks over the last couple of years are due for a breather.

According to Bloomberg data, the combined market value of the "Magnificent Seven" tech companies now exceeds $16.4 trillion - larger than the entire Stoxx 600 European stock market capitalization of $13.7 trillion. This concentration of market capitalization presents both opportunities and risks for investors in 2025.



Recent research from Bridgewater Associates highlights that many of the tailwinds that supported U.S. equity outperformance over the past decade - including globalization benefits, tax cuts, and massive fiscal support - may be shifting. The hurdle for continued outperformance is particularly high for tech stocks, which need sustained high earnings growth to justify current valuations.

Empirical Research Partners notes that momentum stocks are on a "barnstorming run," with the highest quintile of price momentum outperforming by a massive 23% over the past year. Historically, such extreme momentum typically moderates in the following year, suggesting more modest returns ahead for the previous market leadership.

A Broadening Recovery

The good news? Market participation appears to be broadening beyond mega-tech. The financial sector, particularly banks, has seen increasing momentum as yields have risen. This sector rotation could accelerate in 2025 if inflation proves stickier than expected. "The diversity of the momentum cohort has improved because tech's dominance has subsided," notes Empirical Research Partners. "Now it's the financials, and especially the banks, that are overrepresented in the momentum club."

We expect mid-cap and higher quality small cap stocks to outperform the mega-caps and favor the equal-weighted S&P 500 over the market cap-weighted version of the index.

Europe Reawakens?

European stocks have dramatically underperformed U.S. markets for a decade and a half.

However, several catalysts could drive better relative performance in 2025:

1. Attractive absolute valuations as well as relative to U.S. stocks
2. Potential benefit from higher commodity prices and lower representation of technology stocks
3. A weaker U.S. dollar could add a currency tailwind that has been absent for over a decade
4. Green shoots of structural political, economic, and capital markets reform could start to appear
5. Extremely pessimistic investor sentiment

Risks to Market Performance in 2025

- Geopolitical shocks (Taiwan, Middle East)
- Recession in the U.S. or globally
- Policy mistakes (fiscal or monetary)
- Systemic financial stress
- AI disappointment leading to tech selloff

Recapping our Outlook

1. U.S. Equity Returns are positive but Moderate
2. Better Performance Outside the Mega-Caps
3. Fixed Income (especially longer duration) faces challenges
4. Inflation risks accelerating if growth plans are successful
5. Commodities provide an attractive hedge against
6. U.S. Dollar Weakens
7. Europe Reawakens

After years of U.S. mega-cap tech dominance, 2025 could mark a transition toward broader market leadership. While overall returns may moderate, opportunities exist in previously unloved areas like dividend paying stocks, European stocks, commodities, and quality mid-small caps. The key will be maintaining flexibility and watching for signs that the anticipated rotation is actually materializing.

Special Topic

Artificial Intelligence: Still Early Innings of a Long-Term Technological Revolution

Artificial Intelligence (AI) has firmly established itself as one of the defining technological innovations of the 21st century, with the potential to reshape every facet of society and the global economy. Applying Carlotta Perez's framework of technological revolutions from her book *Technological Revolutions and Financial Capital*, we can better understand the evolution of AI and its implications for the future. This analysis explores how AI is currently progressing through the **Installation Period**, where speculative investment dominates, and how it may advance into the **Deployment Period**, where it will mature and transform industries, businesses, and daily life.

Overview of Perez's Framework

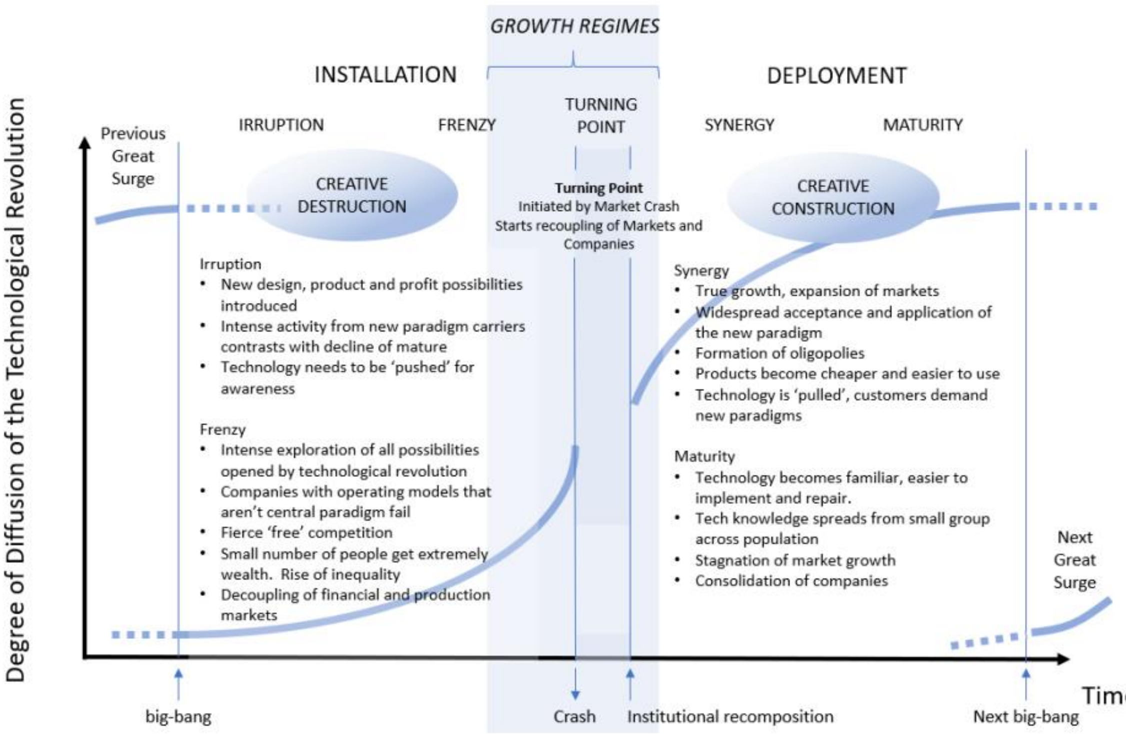
Perez identifies two main periods in a technological revolution:

1. **Installation Period**: A time of experimentation and speculative investment where financial capital funds the infrastructure of the new technology. This period is often characterized by a speculative bubble and a subsequent crash.

2. **Deployment Period**: The technology stabilizes, and its benefits are widely diffused across society, driving sustainable economic growth and significant societal transformations.

By examining AI within this framework, we can anticipate its trajectory and understand its impact on various aspects of society.

Phases of a Technological Revolution

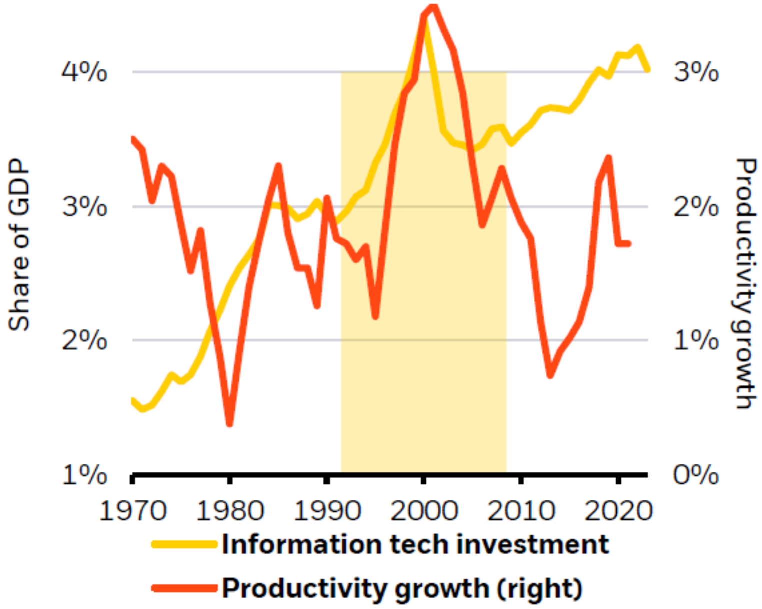


Source: Figure 5.1 in "Technological Revolutions", Perez

The AI revolution is in the Frenzy Phase of the Installation Period, marked by extraordinary investment, rapid innovation, and hype surrounding its potential. Speculative activity in AI is at an all-time high, with companies, governments, and individuals betting heavily on its transformative promise.

Potential reward, but with a lag

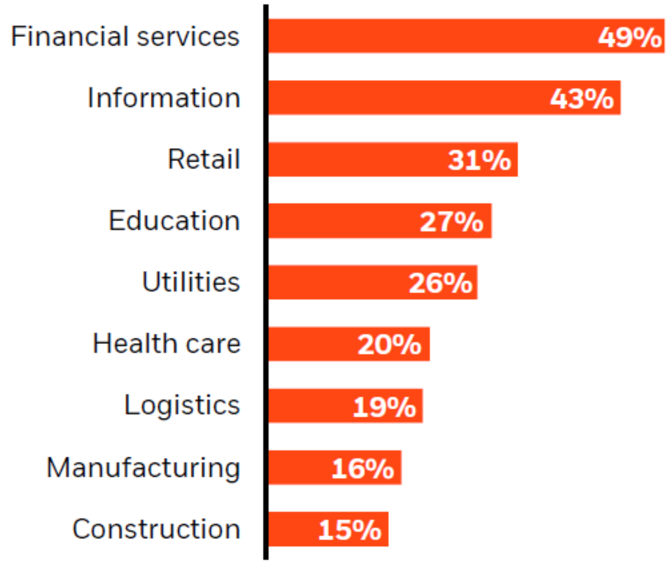
U.S. IT investment rate and trend productivity growth



Source: BlackRock Investment Institute, U.S. Bureau of Economic Analysis with data from Haver Analytics, November 2024. Note: The chart shows the five-year moving average of U.S. nonfarm business sector productivity growth and the rate of investment in information tech processing equipment and software as a share of nominal GDP.

Half the time

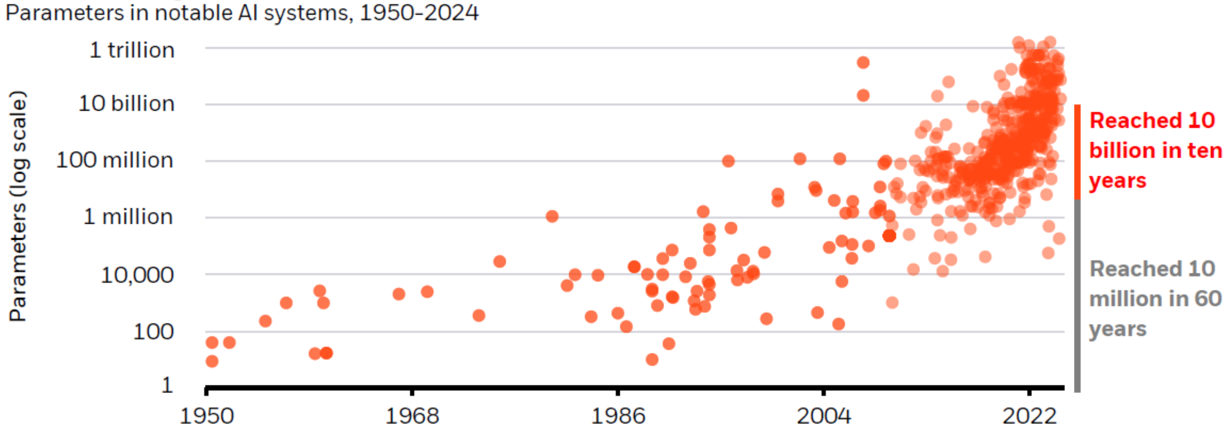
Share of tasks where use AI may halve time taken for task



Source: BlackRock Investment Institute, Eloundou et al (2023), November 2024. Note: The chart uses industry-level AI exposure measure from Eloundou et al (2023) defined as the average share of tasks where access to an LLM or LLM-powered system would reduce the time required for a human to perform a specific task by 50%. We group their results into 2-digit North American Industry Classification System industry groups and show a selection of most and least exposed industries.

Exponential growth

Parameters in notable AI systems, 1950-2024



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Current Industry Dynamics

Technology and Software

- Generative AI: Tools like OpenAI's ChatGPT, Google's Bard, and other large language models (LLMs) are revolutionizing communication, software development, and creativity. Companies are integrating these models into workflows to enhance productivity.

- Enterprise Solutions: Firms like Salesforce and SAP are embedding AI into customer relationship management (CRM) and enterprise resource planning (ERP) tools, enabling businesses to streamline operations and provide tailored customer experiences.

Finance and Investment

- AI is optimizing portfolio management, enabling predictive analytics, and driving algorithmic trading. For example, BlackRock's Aladdin platform uses AI to manage risk and allocate resources.

- Fraud detection powered by AI is becoming standard at major financial institutions like JPMorgan Chase, detecting anomalies in transaction data in real time.

Healthcare

- Diagnostics and Drug Discovery: AI is identifying diseases earlier and more accurately than ever before. Startups like PathAI and large players like Pfizer are leveraging AI for diagnostics and accelerating drug development timelines.

Retail and E-Commerce

- Retailers such as Amazon and Walmart are using AI to optimize supply chains, forecast demand, and provide personalized recommendations. AI-powered chatbots are transforming customer service by providing immediate, 24/7 support.

Energy and Sustainability

- AI is driving energy efficiency through smart grid optimization and renewable energy forecasting. For instance, Google DeepMind has improved energy usage in its data centers by 40% using AI.

Projections for the Next 1-3 Years: Closing the Installation Period

As AI approaches the end of the Installation Period, it will likely experience both spectacular breakthroughs and inevitable growing pains.

Expansion of Generative AI

- Tools like ChatGPT and Microsoft's CoPilot will become ubiquitous in the creative and business sectors, automating tasks such as content creation, software coding, and marketing campaign design.

- AI will increasingly serve as an assistant for professionals in law, medicine, and engineering, reducing mundane workloads and improving productivity.

AI in Transportation

- Autonomous vehicle technology will gain regulatory approvals in certain markets. Companies like Tesla, Waymo, and Cruise may deploy AI-driven fleets for public transportation and last-mile delivery.

Widespread Automation

- Retail and logistics will embrace AI at scale, with robotic warehouses, automated inventory tracking, and cashier-less stores becoming more prevalent.
- Manufacturing industries will adopt AI-driven quality control systems, reducing defects and downtime.

Projections for the Next 10-20 Years: Entering the Deployment Period

AI will embed itself into every sector, creating efficiencies and enabling innovations:

Healthcare

- Real-Time Monitoring: Wearable devices and sensors powered by AI will monitor patients continuously, detecting early signs of illness.
- Robotic Surgery: AI-enabled robotics will perform minimally invasive surgeries with unprecedented precision.
- General Practice physicians and mental health professionals may be increasingly replaced by AI Chatbot tools

Education

- Personalized Learning: AI will adapt educational content to individual students' needs, creating highly effective learning experiences.
- AI Tutors: Virtual tutors, powered by AI, will become commonplace, assisting students in STEM fields and beyond.

Energy and Sustainability

- AI will optimize renewable energy grids, balancing supply and demand to achieve net-zero carbon emissions.
- In agriculture, AI-powered drones will monitor crops, apply fertilizers precisely, and predict weather impacts, increasing yields.

Transportation

- AI-driven logistics networks will reduce delivery times and costs while minimizing environmental impact.
- Fully autonomous public transport systems will improve urban mobility.

In the long-run, AI could add trillions of dollars to the global economy. McKinsey estimates that AI could deliver $13 trillion in annual economic activity by 2030. AI will enhance healthcare, education, and public infrastructure, improving life expectancy and reducing inequality in many regions. While some jobs will disappear, new roles in AI oversight, ethics, and hybrid AI-human collaboration will emerge. By the maturity phase, AI will likely catalyze entirely new industries, such as brain-computer interfaces or AI-driven biotechnology.

Artificial Intelligence is poised to transform industries, elevate productivity, and improve lives worldwide. By applying Carlotta Perez's framework, we can see that AI is currently in the speculative Frenzy Phase but holds the potential to transition into a period of sustainable growth and societal benefit during the Deployment Period. If managed responsibly, AI could usher in a new golden age of innovation and prosperity. However, its challenges must be addressed proactively to ensure equitable and ethical outcomes.

Our job as investors and stewards of client capital will be to identify companies and industries who are most proactively seeking to benefit from artificial intelligence to drive growth and efficiencies while avoiding industries that may be disrupted or displaced entirely. These systems have become exponentially more powerful in recent years, and we anticipate this trajectory to only continue.

Sources

YCharts, Bloomberg, Goldman Sachs Global Investment Research, BofA Global Investment Strategy, Empirical Research Partners, Bridgewater Associates.

[1] Bloomberg

[2] JP Morgan Guide to the Markets as of December 11, 2024.

[3] Transcript of Chair Powell's Press Conference December 18, 2024

[4] As we wrote in our recent piece, What Is Driving The Bond Market?, the Fed sets the target rate which most directly impacts the short-term maturities of the Treasury curve, while market expectations related to inflation and the economy drive long-term rates.

[5] Bloomberg World Interest Rate Probability as of December 23, 2024

[6] https://www.cbo.gov/publication/61136?utm_source=chatgpt.com

[7] https://www.cushmanwakefield.com/en/united-states/insights/infrastructure-investment-and-jobs-act?utm_source=chatgpt.com

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[9] https://www.wtwco.com/en-us/news/2024/07/employers-more-conservative-with-salary-budgets-as-employee-base-stabilizes

[10] https://www.zillow.com/learn/housing-market-predictions/?utm_source=chatgpt.com

[11] https://www.cbo.gov/system/files/2024-09/60191-housing-starts.pdf?utm_source=chatgpt.com

[12] Congressional Budget Office