2025 investment outlook:
A favorable outlook, but our heads are on a swivel

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Executive summary

We begin the new year with a constructive outlook for clients, with solid underlying fundamentals for many asset classes intersecting with policy uncertainty domestically and abroad. Investors enter 2025 with two years of solid momentum for diversified portfolios, led by domestic stock returns. While we continue to focus on growth and inflation as the two principal capital market drivers, geopolitics will receive ample investor attention as 2025 begins. In the U.S., the incoming Republican administration's policy agendas regarding taxes, trade, regulation and immigration will be focal points. As we seek more details, our initial view is favorable for traditionally risky asset classes, although capital markets could react negatively to policies that stoke still-pesky inflation and inhibit the U.S. Federal Reserve's (Fed's) interest rate cutting bias. The domestic corporate profit cycle is strong, and while current earnings expectations for 2025 may prove overly optimistic, we still see domestic equities having favorable fundamentals.

From a global perspective, gauging trade relations and the state of global consumers will be key. Domestic growth impulses remain stronger than most developed countries, and emerging economies face a higher dollar and uncertain tariff outcomes. The world has witnessed political changes and challenges in major economies like Germany, France and South Korea, reminding investors that budgetary discipline matters. We start the year with a favorable view on diversified portfolios and see areas of opportunity despite stretched valuations in certain categories. We wish you and yours a happy and healthy New Year and value the opportunity to share our views.

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Global economic views

U.S. economic exceptionalism continues, while foreign growth remains modest. Tariff and trade policies are key to 2025 economic outcomes.

Despite slowing global growth and inflation, as we close 2024, projections suggest a positive economic backdrop. Through the third quarter, the U.S. grew 2.7% year over year, slower than the 3% pace in the year's first half, but significantly stronger than most developed countries. Growth is likely to moderate further as we progress through 2025, driven by the lagged effects of high interest rates and prices weighing on economic activity. Many global central banks, including the Federal Reserve, are lowering interest rates as inflation risks subside in hopes of engineering "soft landings" for their economies. With U.S. elections concluded, attention now turns to global trade policies. Tariffs appear likely to increase, which could rekindle some near-term price pressures, potentially slowing the pace of global interest rate cuts.

U.S. economic growth is likely to moderate in 2025, but with outcomes significantly better than previously anticipated.

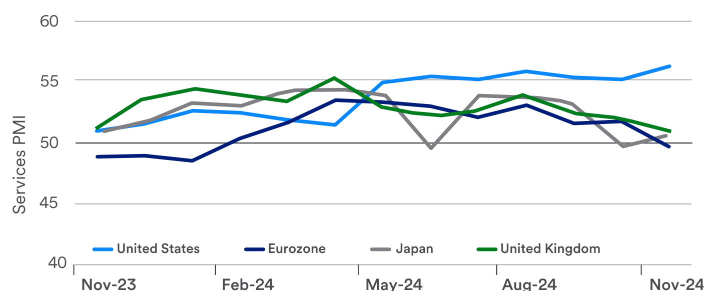
The U.S. economic backdrop remains resilient entering 2025, a surprise to many investors versus year-ago expectations. Consumer spending supported by a robust labor market helped maintain strong economic activity in 2024. The economy appears likely to achieve a soft landing in 2025, aided by slowing inflation and solid domestic demand growth. The U.S. Bank Economic Team calls for only modestly decelerating (but still growing) economic activity in 2025. Interest rates remain higher than during most other periods in the past 25 years. However, wealthier consumers' spending continues driving corporate profits and economic growth. Some modest labor market easing could dampen spending later in 2025.

Inflation rates continue to slow but remain above the Fed's 2% target. The Fed's preferred inflation measure, the core (which excludes food and energy) Personal Consumption Expenditure Price Index, gained 2.8% for the year ending in October. Deceleration should continue in 2025, nearing the 2% Fed target in the second half of the year.

Broad market liquidity, loosely defined as the amount of money circulating in an economy, can influence financial asset prices. Liquidity should improve in 2025 in the U.S. Money supply growth is the highest in almost two-and-a-half years and rising. The Fed is likely to slow or cease its current policy of allowing its bond holdings to mature without investment, which reduces investors' need to absorb as much bond supply. Finally, the U.S. Treasury's cash balance remains high and could inject meaningful cash into the economy if the debt ceiling is not lifted by January 1. These factors contribute to an important liquidity tailwind in early 2025 that may benefit financial asset prices.

Questions remain around policy prioritization and magnitude as we look ahead to President-elect Trump's January inauguration and a Republican Congressional majority. Tariffs and immigration are early focuses. Deportations could tighten the labor market. A drop in the labor force could lead to faster wage growth as businesses compete for labor. Depending on the reaction of the countries and industries involved, higher tariffs could raise near-term costs for consumers, leading inflation to accelerate in the near term and perhaps preventing the Fed from cutting interest rates as much as planned. Productivity and deregulation represent potential positives for the economy. Further acceleration of workforce productivity, or output per hour worked, could offset cost increases and spur an improvement in economic growth. Anticipation around deregulatory efforts by the new administration may already be contributing to stronger business and consumer survey data post-election, although this optimism must be met with actions to sustain sentiment.

Services Purchasing Manager Index (PMI)



Sources: U.S. Bank Asset Management Group analysis, S&P Markit, 11/30/2023-11/30/2024.

Purchasing manager surveys poll business managers regarding whether activity is expanding or contracting. A reading above 50 indicates expanding activity and below 50 indicates contraction. While services activity continues to expand in most developed markets, a notable gap has emerged between the U.S. and foreign developed economies.

Tariffs pose some risks to slow but improving growth in developed markets.

Growth in major developed foreign economies like the eurozone, the United Kingdom (U.K.) and Japan remains subdued. The graphic on the previous page highlights the growing discrepancy between acceleration in U.S. service business activity and stagnation in the developed foreign economies. Activity still appears to be expanding in the U.K. and Japan, although the eurozone data has dipped into slight contraction. Consensus economic growth expectations mimic this gap, with U.S. growth anticipated to be notably higher than most other large, developed economies. Despite these differences, economic activity should still expand at a faster clip than 2024, especially in Japan and the U.K.

Easing monetary policy remains a growth tailwind. The European Central Bank and the Bank of England are cutting interest rates as inflation subsides and growth remains slow. Bond yields reflect expectations of multiple 2025 rate cuts in both jurisdictions. Consumer spending remains key to meeting positive growth expectations, while energy costs and tariffs remain risks. Meanwhile, Japan's central bank is modestly increasing rates, with inflation and wage growth supplanting three decades of deflation. Japan remains a major exporter, and rising tariffs could hurt their economic rebound.

Emerging markets remain diverse as trade policies take center stage while China struggles to rekindle consumer demand.

India continues to lead emerging market growth amid a population growth tailwind and as companies seek to diversify production away from China. In China, significant declines in foreign direct investment compound struggles from weak domestic demand, with the economy bogged down by excess housing and local government debt. Questions remain around the ability of fiscal stimulus to sufficiently and sustainability boost demand. Stable to slightly slowing growth appears to be the most likely outcome for many emerging market economies, with trade policies key swing factors. Asian technology producers such as Korea and Taiwan will be sensitive to artificial intelligence (AI) demand trends and trade challenges. Latin American economies such as Brazil and Mexico remain challenged by low energy prices and the potential for rising tariffs.

U.S. equity markets

Performance in 2024 was superb and broad-based; we expect favorable but more subdued returns in 2025.

The S&P 500, including dividends, returned 28.6% in 2024 through December 18, with all 11 sectors positive and six up 20% or more. Broad-based gains reflect underlying economic strength while rising earnings and improving valuation (the price investors pay for anticipated earnings) bolstered strong index-level performance. For 2025, we foresee a still-favorable environment driving stock prices higher but expect more muted returns relative to 2023 and 2024's outsized gains. Market valuations for large company stocks begin 2025 at elevated levels relative to historical averages but with strong recent earnings growth, while dividend and buyback activity contribute to solid shareholder distributions. We view fundamental growth such as revenues, profit margins and earnings rather than further valuation expansion as a primary return driver. Our published year-end 2025 S&P 500 price target is 6,480, and we will revisit our assumptions and price target near the conclusion of the fourth quarter reporting period in mid- to late-February.

Medium- and small-company stocks finished 2024 on a strong note. Smaller companies are more sensitive to economic impulses than large companies. Stronger-than-expected economic growth boosted sentiment and drove growth-oriented and economically sensitive assets up the most. Smaller companies are also more sensitive to financing costs and stand to benefit the most from lower realized and anticipated policy rates in the U.S. and elsewhere. Valuations outside the largest U.S. stocks are closer to historical averages, providing a degree of protection in the event strong investor sentiment ebbs.

U.S. equity performance

Index	2024*	2023
S&P 500	28.6%	26.3%
S&P 500 Sectors		
Communication Services	45.5%	55.8%
Consumer Discretionary	39.3%	42.4%
Consumer Staples	18.7%	0.5%
Energy	6.0%	-1.3%
Financials	32.2%	12.1%
Health Care	3.4%	2.1%
Industrials	20.9%	18.1%
Information Technology	40.2%	57.8%
Materials	4.0%	12.5%
Real Estate	8.6%	12.4%
Utilities	24.1%	-7.1%

*Through Decemberr 18, 2024.

Sources: FactSet Research Systems, S&P Global. Reflects total returns.

As we begin 2025, the fundamental backdrop promotes a pro-growth orientation.

Waning inflation, moderating interest rates and stable earnings projections will likely support higher-trending U.S. equity prices in the new year. Expense control remains a common theme among companies across all sectors, bolstering profit margins and earnings growth. However, it is unlikely that elevated large stock price-to-earnings ratios expand meaningfully above current levels given post-election policy uncertainties.

Challenges facing President-elect Trump include debt ceiling negotiations, tax cut promises, regulation and immigration reform and fluid foreign trade policies while keeping inflation at bay, boosting the U.S. economy and avoiding a recession. Positive earnings growth and lower interest rates would likely accompany policy decisions that restrain inflation while stimulating economic growth, supporting elevated valuation and equity price return potential. Policies reaccelerating inflation and slowing growth would likely have the opposite effect, impairing investor sentiment and challenging forward equity returns. At a minimum, we expect price volatility in 2025 as each policy decision is discussed and enacted into law.

Consensus earnings growth projections in 2025 over 2024 seem optimistic, presenting a near-term headwind.

As of December 18, analysts forecast S&P 500 earnings of approximately $240 per share for full-year 2024 and $273 in 2025, according to Bloomberg, FactSet and S&P Cap IQ, reflecting respective 9.0% and 13.5% year-over-year growth. Meanwhile, stock market valuation reflects a similar degree of optimism. At current price levels, the S&P 500 trades at 24.5 times the 2024 estimate and 21.5 times 2025 projections, at the high side of its 35-year historical average, though short of extreme valuations. Company guidance following fourth quarter releases, beginning in mid-January, should improve earnings visibility for 2025. We anticipate companies will continue to temper forward guidance given uncertainty around policy outcomes.

Opportunities exist in all market environments; we favor balanced exposure to the technology-oriented growth sectors and income-oriented alternatives.

The world is experiencing a rate of change that has never been faster, and speed, scale and efficiencies do not occur without technology. This presents favorable conditions for AI-related buildout beneficiaries. While individual technology companies may be subject to near-term pullbacks following strong 2024 performance, their longer-term growth theses remain intact, warranting continued exposure even at current elevated valuation levels. Companies focused on data capture, storage, processing, software and analytics, security and distribution appear positioned to benefit from longer-term growth drivers. Additionally, AI data centers will consume disproportionately more electricity than data centers in the past, creating an opportunity for companies involved in expanding electric grid capacity.

Similarly, defensive/income-oriented sectors such as Real Estate, Utilities, Consumer Staples, Industrials and select Healthcare companies should continue to respond favorably to the Fed's less-restrictive policy stance as lower Treasury yields reduce the competition from bonds for dividend-paying securities. Additionally, Utilities sector performance was a standout in 2024, up 24.1%, the fifth-highest-performing S&P 500 sector. Select Utilities companies stand to benefit from anticipated increased power needs associated with data centers and AI-based application buildout.

In aggregate, a balanced approach combining growth-oriented technology and defensive sectors provides exposure to evolving technologies while capitalizing on favorable risk profiles of sectors and companies during periods of economic uncertainty and a lower interest rate environment.

Foreign equity markets

Accommodative central bank policies, stable but modest economic growth and strong shareholder distributions offset subdued earnings growth expectations informing our constructive foreign equity outlook.

U.S. and foreign equity performance, fundamentals and valuations diverged in 2024. Foreign developed equity markets delivered one quarter to one third the returns of U.S. markets after accounting for currency translation, delivering yearly gains of a modest 5.4% for U.S.-based investors. Notably differing valuations, which are near historical norms for developed markets, combined with lower earnings growth in 2024 and lower expected earnings growth in 2025 explain the difference versus superb U.S. stock market returns. Elevated interest rates, stagnant economic growth and proximity to an escalating Russia/Ukraine conflict continue to weigh on consumer sentiment and corporate profit growth expectations. However, strong current shareholder

distributions paired with cheaper valuations bolster the defensive characteristics of developed foreign stocks, which complement the more growth-reliant characteristics of domestic stocks.

Central banks throughout the European region continue to provide monetary policy stimulus to reignite economic growth. The European Central Bank lowered interest rates by 0.25% at its final 2024 meeting, with falling energy prices and decelerating wage inflation driving investor expectations for an additional 1.25% of rate cuts in 2025. Additionally, interest rate markets anticipate the Bank of England will lower rates by 0.50% next year, providing further monetary stimulus. Reduced borrowing costs should support increased credit demand and reaccelerate economic activity as inflation eases, driving a corporate profit upgrade cycle.

Investor sentiment around developed foreign stocks remains poor, evidenced across fund flow data, valuations, earnings expectations and the resulting stock price performance relative to U.S. markets in 2024. Fund flow data highlights a significant discrepancy between stagnant capital flows into developed foreign equities relative to robust flows into U.S. equity funds. Valuations also reflect somewhat pessimistic investor sentiment relative to historical averages. Price-to-earnings ratios are just below 15 compared to 24.5 for large U.S. stocks, around 12% below the 20-year average. Analysts have progressively marked down 2025 corporate profit growth estimates from 8.1% at the beginning of 2024 to 4.0% at this year's conclusion. The collectively negative relative sentiment toward developed foreign stocks presents an opportunity for prices to revalue higher if continued central bank accommodation and decelerating wage inflation boost 2025 analyst earnings growth expectations or if overall investor sentiment turns less negative. While investors await improving sentiment, we see benefit from an approximate 3% dividend yield plus 1.5% share buyback yield.

A positive global economic backdrop, improving economic forecasts and reasonably inexpensive valuations should benefit emerging market equities, although tariff and trade risks remain.

While emerging market equity return drivers have evolved over the past decade, one constant remains: The region's pro-growth orientation. Defensive sectors including Consumer Staples, Health Care and Utilities, which tend to outperform when economic growth slows or contracts but underperform during strong growth cycles, represent only 12% of the MSCI Emerging Market Index versus 25% for foreign developed equities. However, the growth sector composition has evolved to a nearly even split between longer-term, secular growth sectors such as Technology and sectors that tend to ebb and flow with economic cycles, including Financials.

China, India, Taiwan and South Korea comprise nearly 75% of the emerging market equity universe. In October, the International Monetary Fund upgraded its 2025 economic growth forecast for the emerging Asia region from 4.8% to 5.0% based on an improved outlook for China, though Korea's political uncertainty could impair the region's near-term growth potential. While economic growth and stock market prices can periodically diverge, analysts continue to forecast improving profit growth from near 12% in 2024 to 13.5% in 2025.

Like foreign developed equities, improving investor sentiment represents a potential catalyst for positive equity market performance. Valuations appear somewhat inexpensive when considering solid growth prospects and the growth-sensitivity of emerging market stocks, despite upgraded economic growth forecasts and double-digit profit growth expectations. Improving investor sentiment hinges on positive 2025 outcomes for emerging markets' growth drivers such as India's continued economic development and rising middle class, Taiwan's key role in the global technology and AI supply chains, and global demand for South Korea's consumer and industrial goods. Perhaps most importantly, China's progress in shoring up property markets, stimulating domestic demand and addressing the decline in foreign direct investment will likely dictate the degree to which investors unlock price appreciation opportunities in Chinese stocks, which comprise approximately 25% of the emerging market index.

Combining emerging market economies into a single group masks a diverse and often disparate mix of investment considerations. For example, India has been a powerful growth engine, yet lofty valuations raise the bar for continued share price appreciation. China temporarily boosted share prices via fiscal stimulus, but deteriorating fundamentals suppress valuations and could see further pressure from increasing U.S. tariffs. Vietnam benefited from U.S. and European importers seeking to diversify supply chain dependencies out of China.

Fixed income markets

Bond yields suggest strong income opportunities in fixed income for 2025, albeit with potentially limited price appreciation.

Treasury yields rose in the fourth quarter through mid-December, contributing to solid income opportunities across bond markets. Bond prices move in the opposite direction of interest rates, meaning the increase in Treasury yields dampened returns. Some riskier, lower-quality bond categories like high yield corporates and municipals generated enough income to offset price declines and delivered modestly positive returns. Returns were slightly negative on high-quality bonds like Treasuries, agency mortgages and investment-grade corporate and municipal bonds in the fourth quarter through mid-December. While bond price declines were a headwind in the fourth quarter, higher yields improve opportunities to generate current income.

Strong credit fundamentals supported the outperformance of riskier high yield bonds over Treasuries in 2024, but prices largely reflect fundamental tailwinds given elevated valuations. The difference in corporate bond yields relative to Treasuries remains below historical averages, meaning investors receive less excess income as compensation for the risk of default and price volatility. For investors with taxable accounts, the difference between municipal bond yields and Treasuries is also slightly below its long-term average. However, absolute return opportunities in corporate and municipal bonds remain compelling. Corporate bond yields generally range from 4.8% to 7.3% depending on credit rating,[1] while highly taxed individuals can achieve tax-equivalent yields of 6.0% on investment-grade bonds to 9.0% on high yield municipal bonds.[2]

Diversifying credit exposure can capture opportunities across the fixed income landscape. Bond categories like non-agency mortgages, structured credit and reinsurance provide meaningful income derived from sources outside of traditional corporate credit risk. Investors with taxable accounts can find opportunities in high yield municipal bonds that historically experience low defaults but still generate significant extra yield in comparison to higher-quality investment-grade bonds.

Yield opportunities in bonds

*Municipal bond yields are tax adjusted with the highest federal tax bracket of 37% plus the 3.8% Affordable Care Act income tax.

Sources: Bloomberg, January 2, 2004-November 26, 2024. Yields are based on Bloomberg Aggregate Bond Index, Bloomberg High Yield Corporate Bond Index, Bloomberg Municipal Bond Index, Bloomberg High Yield Municipal Bond Index. See index definitions in the disclosure section.

The Federal Reserve initiated interest rate cuts in 2024's second half, with expectations for additional cuts in 2025.

The federal funds rate ends 2025 in a range of 4.25% to 4.50%, below the elevated range of 5.25% to 5.50% it reached in 2023 and remained in for much of 2024 to dampen inflation. The Fed sets the baseline cost of borrowing money through the short-term fed funds rate to manage its goals of stable prices and full employment. Inflation remains slightly above the Fed's 2% target and unemployment remained stable in the fourth quarter, contributing to moderating investor expectations for additional cuts ahead. Bond yields suggest investors expect just one of two more 0.25% rate cuts in 2025 for a funds rate of around 4.00%. This implies investors expect monetary policy to remain moderately restrictive next year in comparison to the Fed's estimate of a neutral policy rate around 3%, partially in reaction to stronger consensus expectations for 2025 economic growth than previously anticipated. The increase in Treasury yields in the fourth quarter to incorporate more conservative cutting expectations improves the balance of risks for bonds. High-quality bonds can contribute important diversification benefits while generating stable income as the Fed patiently eases policy settings.

Growing fiscal spending elevated Treasury supply to fund deficits. Investor attention is turning to the potentially unsustainable long run path of the federal budget. However, sufficient investor demand for additional Treasuries prevented market disruptions in 2024. Investor attention and resultant bond yields focused more on stronger economic data than

[1] Based on Bloomberg AAA U.S. Corporate Index and Bloomberg U.S. Corporate High Yield Index.

[2] Based on Bloomberg U.S. Municipal Bond Index and Bloomberg High Yield Municipal Bond Index and applying the 37% top federal income tax bracket plus 3.8% Affordable Care Act tax.

fiscal worries. Government spending is projected to remain elevated with or without an extension of the Tax Cut and Jobs Act in 2025, according to the Congressional Budget Office,[3] but the supply versus demand backdrop for Treasuries may improve somewhat in 2025. We expect the Federal Reserve to moderate or conclude its ongoing effort to shrink its bond holdings in 2025, which should offset a portion of new supply. Any increase in yields, along with currency fluctuations, may also draw in foreign investor demand. While fiscal concerns remain problematic over the long run and can dent investor sentiment, we believe yields adequately compensate for this risk for the time being.

Spreading allocations across various bond types helps limit the impact of price swings of any individual bond category while still delivering meaningful income over time.

Opportunities for corporate bond prices to richen further relative to Treasuries are limited given current valuations, but absolute yields, particularly for lower-rated bonds, remain compelling. In addition to the to 7% yields in high yield corporate bonds and 9% tax-equivalent yields in high yield municipals for highly taxed investors, meaningful income opportunities also exist elsewhere. Investors can achieve yields in the 6% to 8% range on mortgage bonds not backed by the government (non-agency mortgages). Most home-owners remain in solid financial condition from a stable labor market and having locked in low mortgage rates, providing solid fundamental support for non-agency mortgages. Furthermore, home equity relative to home values in the U.S. has reached an all-time high, creating ample equity cushions for first lien mortgages and a strong incentive for borrowers to remain up to date on interest payments. Insurance-linked securities (reinsurance) generate more than 10% annual income right now to compensate for the risk of natural catastrophes triggering insurance claims and the resulting payouts. In addition to the meaningful return potential, reinsurance, which is sensitive to weather events, provides added portfolio diversification versus traditional assets that are more sensitive to economic cycles.

Real asset markets

Real assets delivered mixed results into year-end but present opportunities to aid portfolio returns going forward if inflation reasserts itself.

Rising interest rates, steady economic growth, geopolitical tensions and anticipated federal regulation changes posed nuanced headwinds and tailwinds to segments of the real asset market in 2024. Rising funding costs acted as a headwind to publicly traded real estate stock prices in the fourth quarter, but strong economic data and strengthening expectations for 2025 growth acted as a tailwind. On balance, real estate investment trust (REIT) share prices fell slightly in the fourth quarter, but most real asset categories delivered strong returns over the course of the year, with economic growth proving more resilient than many economists originally forecasted. Solid income distributions and steady economic growth trends provide a positive baseline outlook for real assets with the added benefit that real assets can help protect against risk of a resurgence in inflation.

Sound fundamentals back reasonable income returns from real REITs.

Broad REIT exposures include properties that generate on average 6% net operating income yield, a historically normal reading that suggests prices are reasonable compared to fundamentals. Importantly, vacancies remain contained, with weakness concentrated in property types where public market valuations have already reset lower, like office real estate. While office vacancies are high, investor optimism is recovering as companies encourage employees back to offices and some developers find value in converting office properties to residential buildings. Office REITs comprise less than 4% of broader publicly traded REIT indices, mitigating the impact to investors of additional headwinds in this asset class. Categories like industrial properties continue to exhibit fundamental tailwinds with strong demand supporting low vacancies and solid rent growth.

Rising Treasury yields became increasingly competitive with real estate income in the fourth quarter, but property income grew at a healthy pace. Publicly traded real estate valuations are somewhat elevated but offer the benefit of income growing alongside real economic growth and inflation. Economists' forecasts for around 2% real growth plus 2%-3%

[3] The Congressional Budget Office is an independent agency that provides nonpartisan analysis and estimates to the U.S. Congress on federal economic and budgetary matters.

inflation in 2025 establish a healthy economic backdrop in support of real estate valuations. In addition, higher interest rates already reflect resilient economic growth, mitigating a degree of repricing risk for REITs and creating incremental return potential if interest rates fall.

Commodity opportunities hinge on economic expansion, inflation, or both.

With stable growth and inflation, broad commodity exposures delivered slightly negative returns in the fourth quarter. Gold prices reached new all-time highs early in the quarter but swung lower after election results removed the political uncertainty that can drive gold demand. Some cited concerns over U.S. fiscal sustainability as a catalyst for gold price gains earlier in the year, but this was not corroborated by rapidly rising Treasury yields. Lingering geopolitical risk may fuel further swings in gold, often boosting gold prices when uncertainty drags on stock and bond returns. Other commodities like oil and industrial metals are sensitive to economic growth. Economist expectations for a mild expansion in economic activity in 2025 moderate potential returns on broad commodity exposures, but any hint of a resurgence in inflation could benefit commodities as a unique portfolio hedge.

Alternative investments

Hedge fund managers' risk appetite increased after the U.S. election.

Hedge fund managers found ample trading opportunities within rapidly changing macroeconomic conditions in 2024, and tactical managers who stay nimble and can trade quickly remain well suited for the current environment. Managers' strong start to the year included positive returns relative to benchmarks across securities purchased long as well as those sold short before performance turned choppier in the summer months. The August market selloff due to concerns about the U.S. economy and the Bank of Japan's surprise interest rate hike led hedge fund managers to reduce leverage and net market exposure (total securities invested long less securities sold short) compared to more aggressive positioning in the year's first half. In the third quarter, managers repositioned their portfolios not only for U.S. election outcomes but also ongoing geopolitical risks, central bank interest rate policies and the new administration's potential impact on corporate merger and acquisition (M&A) activity. Hedge funds' overall net exposure was low going into the U.S. election to protect from potential market downside in the event of an uncertain or contested outcome. Their cautious positioning allowed for a starting point from which to tactically lean, and managers quickly increased their risk appetite across a wide variety of strategies and shifted portfolios to a net long position.

Overall, hedge fund performance in 2024 trailed the strong returns generated by U.S. equity markets. Equity market neutral, a strategy buying long select securities while selling short others to isolate security selection and hedge overall market risk, returned 8% through December 18 and was one of the best-performing strategies this year. Fixed income managers pursuing relative value and arbitrage opportunities (similar assets trading at dissimilar prices) produced mid-single digit returns, comparable to broad bond market performance. Multi-strategy funds delivered the most consistent and positive performance; however, returns among these managers varied widely compared to equity correlated strategies.

This year's changing macroeconomic landscape presented opportunities and challenges for macro strategies. Systematic macro strategies (trend-following) that benefit from directional market movements were hurt by midyear trend reversals, including the U.S. dollar, and gave back gains generated earlier in the year. Discretionary macro strategies outperformed in the second half of the year as changing monetary policy, currency values and economic growth rate expectations provided a variety of profitable trades. Meanwhile, event-driven strategies were lackluster beyond select distressed bond opportunities and activist managers. Shareholder activists generated a 7% return this year and initiated a record number of investment campaigns globally, most notably in Japan.

In response to an increasingly volatile market around concerns about economic uncertainty, geopolitical unrest and contested elections, investors seeking risk mitigation strategies helped drive hedge fund capital to record highs this year. Hedge fund assets grew from a combination of performance and new investor inflows, led by relative value arbitrage and equity hedge strategies. Event-driven strategies are also gaining renewed interest from investors anticipating a strong post-election M&A cycle. This contrasts with earlier this year, when equity market neutral, multi-manager and health care sector specialists received the most attention; investors believed these strategies offered greater stability amid geopolitical, monetary policy and election uncertainty.

Within health care, early-stage biotech (companies with products in clinical trials versus those in commercial production) remained a volatile subsector due to interest-rate sensitivity.

Biotechnology stocks largely abandoned by hedge funds in 2024 may now be an attractive area for those focused on sector dislocations. Similarly, we are seeing managers more active recently in the financial services sector, seeking to exploit perceived relative mispricing between small and regional banks. As we head into 2025, we are monitoring the hedge funds' factor rotation into value stocks while trimming growth and momentum stocks. We are also watching the increase in hedge fund strategies launched to investors as semi-liquid mutual fund products. A new year also brings industry change potentially disruptive to short sellers. The Securities and Exchange Commission amended a rule last year that requires hedge fund managers to disclose some short sale positions, information they previously were allowed to keep private.

Private markets

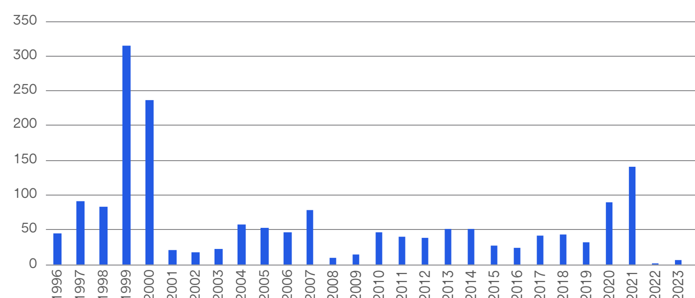
Potential policy shifts and continued economic strength bode well for private markets in 2025.

At the beginning of 2024, markets expected the Fed to cut its policy rate seven times after core inflation decelerated from 5.0% to 3.0% throughout 2023. However, in early 2024, inflation remained stubbornly above the Fed's target level and the Fed held interest rates steady until September, delaying private market deal activity due to an uncertain macroeconomic outlook and elevated interest rates. M&A activity remained 10% below the 10-year average for a second consecutive year, an unusual occurrence even when compared to the global financial crisis of 2007-2008 when activity reverted within a year. Investor pressure continues to build on managers to sell their portfolio companies and unlock value, with average hold periods at all-time highs. There is a similar backlog of companies waiting to list on public stock exchanges via an initial public offering (IPO).

Executives at global investment banks, on a recent earnings call, indicated a substantial pickup in deal activity volume that could translate into realized deals over the next six to 12 months. Lower borrowing costs benefit private equity, and benefits will continue to accrue as the Fed cuts rates further, provided inflation trends toward the 2% target. Meanwhile, economic growth, supported by resilient consumer activity, boosts confidence for corporate and private equity buyers. Corporate M&A activity already increased by 15% in 2024's third quarter compared to last year, and private equity should follow suit.

Policy shifts by the incoming Trump administration may provide a mixed picture, with potential deregulation a positive and a reversal in net immigration and tariffs on imports creating possible headwinds. Under the new administration, regulators could take a less stringent stance toward M&A unlocking deals that were previously likely to be blocked or scrutinized. However, the difference in what buyers and sellers consider fair value is converging, supported by elevated public market valuations. As deal activity picks up, we believe returns on private equity should catch up to public equity returns, and investors can expect more distribution of capital from fund managers. After a bumpy ride following the COVID pandemic, private market investments stand to benefit from more balanced conditions.

U.S. technology IPOs



Sources: U.S. Bank Asset Management Group research, Coatue, June 2024. Includes U.S. listed and SEC registered IPOs exceeding $30 million, along with 34 special purpose acquisition companies in 2020 and 19 in 2021.

Attractive opportunities exist in 2025 informed by our thesis-driven research.

While the investment industry extols the virtues of private markets as if all investments will deliver strong absolute returns, the reality is nuanced. Performance varies significantly across both investment managers and strategies such that the most successful investment manager within a specific strategy could still underperform the broad asset class if the strategy was challenged during a certain period. For example, an investment manager focused on office buildings would have underperformed the overall real estate category if he or she invested in offices prior to the pandemic. We strongly believe that our thesis-driven approach informed by capital markets, secular trends, dislocations and market

exuberance is well-suited to deliver against expectations. Even for a given thesis, picking a quality investment manager is a tall order requiring pattern recognition and expertise. Opportunities we'll prioritize in 2025 include:

- **Sports and media-related ecosystems and intellectual property:** Buying sports teams is a hobby for the ultra-rich. Growth in online media and merchandizing related to intellectual property presents commercial opportunities other investors can also benefit from.
- **Commercial real estate debt:** Banks and insurance companies have pulled back given the dislocation in commercial real estate. Smaller regional banks need solutions to offload some of their loan books. This presents a unique opportunity for investors to earn attractive returns.
- **Hydrocarbons:** Demand for natural gas and oil is expected to persist despite progress on energy transition. Capital investment in this area is at historical lows, presenting an opportunity for investors.
- **The marriage of electrons and atoms in the application of AI:** Technological advancements create opportunities to invest in the application of AI in the physical world — in cars, biotech, industrial automation, home and other areas.

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Past performance is no guarantee of future results. All performance data, while deemed obtained from reliable sources, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for investment. The **S&P 500 Index** is an unmanaged, capitalization-weighted index of 500 widely traded stocks that are considered to represent the performance of the stock market in general. The **S&P 500 Total Return Index** includes the same stocks but includes the reinvestment of dividends. The **MSCI EAFE Index** includes approximately 1,000 companies representing the stock markets of 21 countries in Europe, Australasia and the Far East (EAFE). The **MSCI Emerging Markets Index** is designed to measure equity market performance in global emerging markets. The **Renaissance IPO Index** is a stock market index based upon a portfolio of U.S.-listed newly public companies, before their inclusion in core equity indices. The index reflects approximately the top 80% of newly public companies in capitalization terms, is weighted by float capitalization and imposes a 10% cap on the weight of large constituents. The **Personal Consumption Expenditures (PCE) Price Index** is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. It is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. The **Bloomberg U.S. Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market and includes U.S. dollar denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers. The **Bloomberg U.S. Corporate High Yield Bond Index** measures the U.S. dollar denominated, high yield, fixed-rate corporate bond market. The **Bloomberg U.S. Municipal Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar denominated, fixed tax-exempt bond market. The index includes state and local general obligation, revenue, insured and pre-refunded bonds. The **Bloomberg High Yield Municipal Bond Index** is an unmanaged index consisting of non-investment grade, unrated or below Ba1 bonds.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. The value of **large-capitalization stocks** will rise and fall in response to the activities of the company that issued them, general market conditions and/or economic conditions. **Stocks of small-capitalization companies** involve substantial risk. These stocks historically have experienced greater price volatility than stocks of larger companies and may be expected to do so in the future. **Growth investments** focus on stocks of companies whose earnings/profitability are accelerating in the short term or have grown consistently over the long term. Such investments may provide minimal dividends, which could otherwise cushion stock prices in a market decline. Stock value may rise and fall significantly based, in part, on investors' perceptions of the company, rather than on fundamental analysis of the stocks. Investors should carefully consider the additional risks involved in growth investments. **Value investments** focus on stocks of income-producing companies whose price is low relative to one or more valuation factors, such as earnings or book value. Such investments are subject to risks that their intrinsic values may never be realized by the market, or such stocks may turn out not to have been undervalued. Investors should carefully consider the additional risks involved in value investments. **International investing** involves special risks, including foreign taxation, currency risks, risks associated with possible difference in financial standards and other risks associated with future political and economic developments. Investing in **emerging markets** may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in **fixed income securities** is subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investments in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in **high yield bonds** offer the potential for high current income and attractive total return but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer's ability to make principal and interest payments. The **municipal bond market** is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes but may be subject to the federal alternative minimum tax (AMT), state and local taxes. There are special risks associated with investments in **real assets** such as commodities and real estate securities. For commodities, risks may include market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties (such as rental defaults). **Hedge funds** are speculative and involve a high degree of risk. An investment in a hedge fund involves a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage and short sales, which can magnify potential losses or gains. Restrictions exist on the ability to redeem or transfer interests in a fund. **Private capital investment funds** are speculative and involve a higher degree of risk. These investments usually involve a substantially more complicated set of investment strategies than traditional investments in stocks or bonds, including the risks of using derivatives, leverage, and short sales, which can magnify potential losses or gains. Always refer to a Fund's most current offering documents for a more thorough discussion of risks and other specific characteristics associated with investing in private capital and impact investment funds. **Private equity investments** provide investors and funds the potential to invest directly into private companies or participate in buyouts of public companies that result in a delisting of the public equity. Investors considering an investment in private equity must be fully aware that these investments are illiquid by nature, typically represent a long-term binding commitment and are not readily marketable. The valuation procedures for these holdings are often subjective in nature. **Private debt investments** may be either direct or indirect and are subject to significant risks, including the possibility of default, limited liquidity and the infrequent availability of independent credit ratings for private companies.

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