NATIXIS INVESTMENT MANAGERS | SOLUTIONS

MACRO COMMENTARY | January 2025

PORTFOLIO ANALYSIS & CONSULTING

Charts and Smarts®

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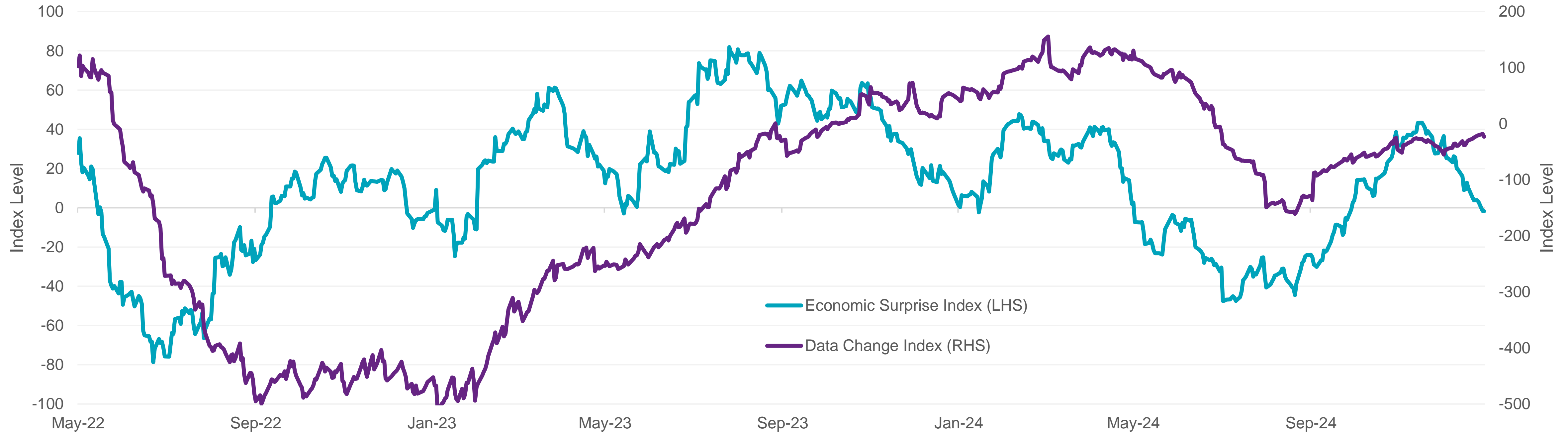
Stormy Weather

Citi Economic Surprise vs Data Change Index (5/2/22–12/31/24)



Just one year ago, we were pounding the table that growth expectations were far too pessimistic as consensus forecasts reflected a robust expansion hitting a wall in the first half of 2024. Our expectation was that estimates would need to move aggressively higher to catch up with the reality of strong and stable growth, a theme which certainly played out over the course of the year. As we flip the calendar into 2025, however, we have an expectations problem of the opposite kind. In the wake of continued upside growth surprises, the consensus has now grown overly sanguine on growth and predictably overly pessimistic on inflation. While we don't foresee a recession by any means, we do see reason to expect growth to moderate over the coming quarters. Federal defense spending has been running at a torrid pace in recent quarters, and while we certainly expect defense spending to remain firm as the US attempts to replenish depleted stockpiles, the pace is likely to moderate. State and local government spending is also set to cool as budgets continue to normalize from the post-pandemic surge. Consumer spending is likely to ease as consumption has outpaced real wage growth in recent months, thanks to continued cooling in the labor market. Finally, housing remains in stasis as mortgage rates have pushed back above 7%, putting a damper on an already tepid residential construction market in the coming quarters. Starting points matter, and these headwinds are simply shaving off growth from an economy that has grown 3%, on average, in real terms, over the past six quarters. Hardly reason to panic, but with a consensus that has grown overly complacent on the growth outlook, moderating growth has the potential to trigger a meaningful repricing of the outlook.

Source: Portfolio Analysis & Consulting, Bloomberg.

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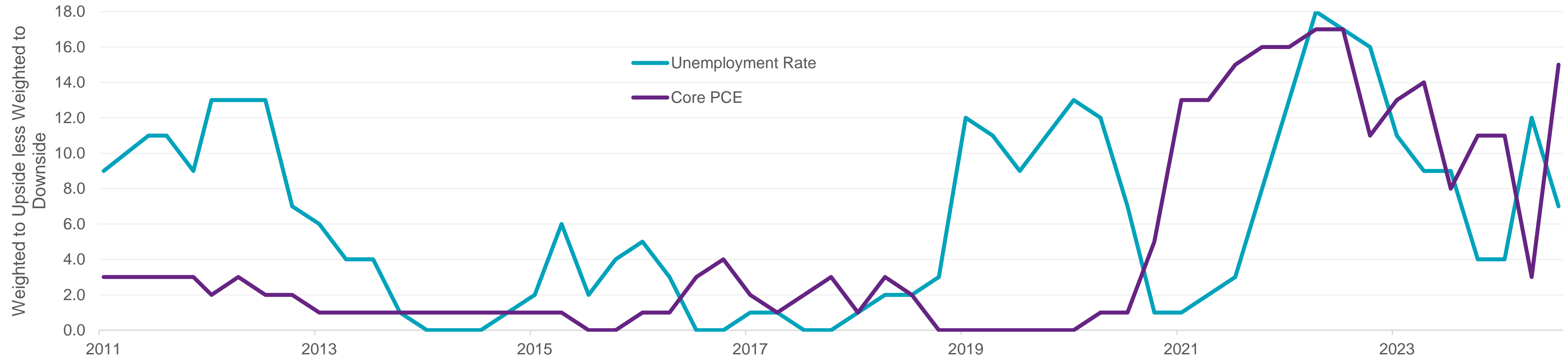
Where Is My Mind?

Diffusion Indices of FOMC Participant Risk Weightings (6/30/11–12/31/24)



It's not just markets that now find themselves offsides with respect to the balance of risks, but the Fed as well. Time and again we've heard from Powell and Company that growth remains strong, and while that has been true, it demonstrates a degree of complacency with respect to the outlook. Growth is set to cool from robust levels, and while the ultimate landing zone for growth is likely to remain healthy, that backdrop contrasts greatly with the Fed's revised dot plot and assessment of the balance of risks at the December FOMC meeting. While we stress that the Summary of Economic Projections (SEP) and the included dot plot are simply a messaging tool, as opposed to a promised path of policy, the message from the latest edition is surprising, to say the least. Recent inflation prints have indeed been warmer, but CPI has overstated the stickiness, relative to PCE, and most importantly, the culprits behind the firming in PCE are largely imputed prices that are a function of idiosyncratic or methodological dynamics, as opposed to broad underlying inflationary pressures. Under the surface, the disinflationary trend remains alive and well. Meanwhile, labor market data, while noisy, given strike and storm effects, has continued to show signs of cooling. While we'd still characterize that cooling as normalization, the risks remain very much skewed to the upside with respect to the unemployment rate, as labor markets remain in stasis. In other words, from our perch, little changed with respect to the balance of risks over the closing months of 2024, and yet, the December SEP now appears more hawkish than was the case in June, with inflation once again taking precedence over the labor side of the mandate. While this abrupt shift may reflect some FOMC participants' expectations of tariffs, Powell himself mentioned the Fed's own research in a 2018 edition of the Teal Book that suggests the Fed should look through tariffs as a one-time price level adjustment. Whether a function of recent data flow or FOMC members prematurely incorporating unknown policies, the Fed's current rhetoric looks very much offside in the hawkish direction. As always, the actual data will dictate that path of policy, not conditional forecasts, and that data is likely to facilitate a dovish pivot as we work through the first quarter.

Source: Portfolio Analysis & Consulting, Bloomberg. FOMC represents Federal Open Market Committee. PCE represents Personal Consumption Expenditures Price Index.

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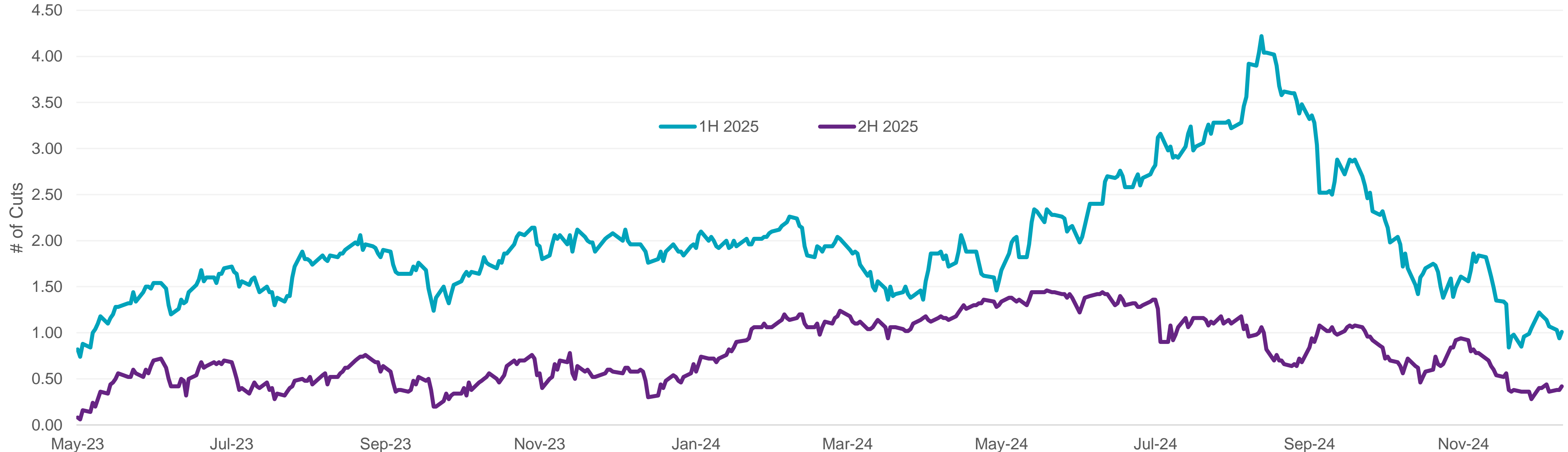
Blown Away

SOFR Implied Cuts 1H 2025 vs 2H 2025 (5/31/23–1/2/25)



With markets and the Fed clearly leaning overly hawkish, it should be no surprise that an asymmetry has emerged with respect to market pricing of policy rates. The SOFR curve is now pricing in just one cut for the first half of 2025, with less than half of another cut priced for the balance of the year. Put simply, the Fed's revised dot plot at the December meeting was simply catching up to where markets were already trading, and since that meeting, markets have continued to lean further in the hawkish direction. That's right, another hawkish overshoot. So how does this overshoot resolve? In our view, that overshoot likely resolves in stages. Early signs of cooler growth and softer inflation are likely to once again bring the Goldilocks narrative to the forefront, prompting a rally in rates and helping to fuel a rally in equities, particularly for rate-sensitive portions of the market. But as is tradition, markets are likely to extrapolate that cooling into a more pernicious slowing in growth. While the Powell Put is very much in play, the risk is a function of timing. Should that extrapolation phase occur in mid-Q1, there's the risk of markets pulling back as investors price in a growth startle before that dovish pivot comes from the Fed around the March meeting, and economic data proves not to be recessionary. At that point, with rates cooling off to around 4%-4.25%, sentiment and positioning back onside, and entry points more attractive, we could see equities mount a broader and more durable rally.

Source: Portfolio Analysis & Consulting, Bloomberg. SOFR represents secured overnight financing rate.

Hey

S&P 500® Earnings Growth vs GDP Growth Regimes (1989–2024)

Earnings Growth vs GDP Growth Regimes

US Nominal GDP % YoY	S&P 500® LTM EPS % YoY	S&P 500® NTM EPS % YoY
<-2%	-33.6%	-21.7%
-2% to 1%	-44.0%	-16.0%
-1% to 0%	-29.7%	-17.8%
0% to 1%	-3.6%	-16.5%
1% to 2%	NA	NA
2% to 3%	-10.0%	-5.3%
3% to 4%	6.5%	7.2%
4% to 5%	16.6%	9.0%
5% to 6%	9.9%	9.3%
>6%	14.1%	15.1%

While we expect growth to moderate, as we've stressed time and again, starting points matter. Real growth cooling from 3% to closer to trend around 2.25%-2.50% is hardly a dire scenario. And with inflation settling down to target over the course of the year, nominal growth is likely to fall around 4.5%. Recall that nominal growth is your best proxy for revenue growth, so with top lines growing 4.5% and margins continuing to grind higher, it's not unreasonable for the S&P 500® to see high single-digit earnings growth in 2025, exactly what the index has historically posted in environments of 4%-5% nominal growth. We're certainly not fans of tossing out price targets or return forecasts – after all, if we're right it's luck and if we're wrong, we'll never hear the end of it. Not a great asymmetry there. But since that's what everyone expects at this time of year, here's how we think about the return potential for this year. Start with earnings growth of 9%, the historical average for our expected nominal growth environment, add on a modest forward dividend yield just over 1.25%, and you're looking at a 10% return, even without any multiple expansion. Add in not even a single turn in the forward multiple and you're at nearly 15% for the year. Multiples are the hardest part of the estimate, given they are purely a function of risk appetite, but the key is this: while the path ahead may not be as smooth as the low volatility advance of the past year, the macro backdrop remains supportive for a healthy floor for equity returns in the year ahead.

Source: Portfolio Analysis & Consulting, Bloomberg. EPS represents earnings per share. LTM represents last 12 months. NTM represents next 12 months. LTM EPS data from 1989, NTM data from 1997.

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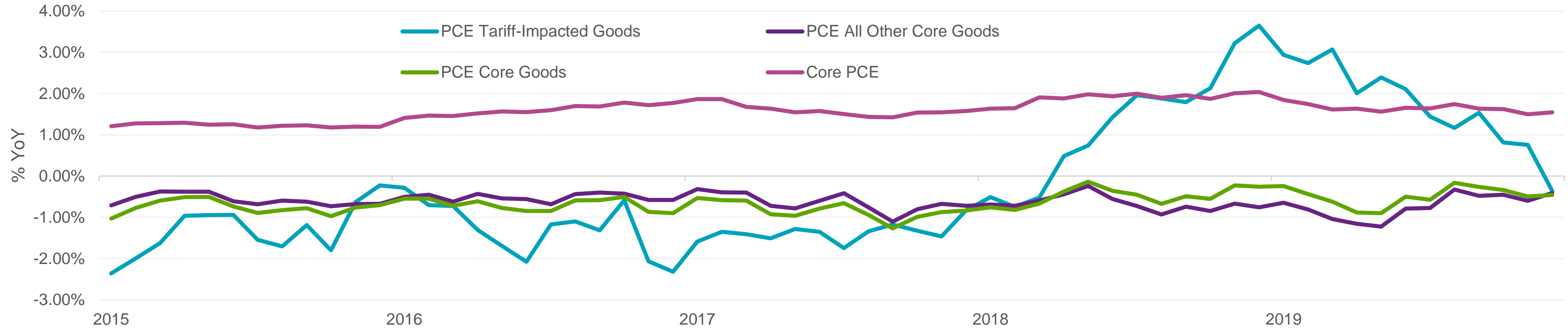
Debaser

PCE Core Goods vs Tariff-Impacted Goods (1/31/15–12/31/19)



While the broad macro backdrop remains supportive for markets in 2025, the elephant in the room is certainly the plethora of unknowns with respect to the incoming administration's tariff strategy. So far, markets have very little visibility into how broadly and aggressively tariffs are likely to be implemented. For now, investors seem to be sticking with the adage that one should take Trump seriously, but not literally. And while markets have found solace in the fact that Treasury Secretary nominee Scott Bessent seemingly favors a transactional and incrementalist approach to tariffs, the simple fact is there remains plenty of uncertainty surrounding tariffs. While those risks loom over markets and the economic outlook for 2025, and appear to be affecting some FOMC members' assessments of appropriate policy and balance of risks, the effects of tariffs and the suitable policy response isn't as clear cut as some might suggest. The experience of 2018 suggests that the commonly held view that tariffs are inflationary may be misguided. While tariff-affected categories certainly saw large price increases which came through in a higher inflation rate through 2018 and early 2019, the rate of price increases settled back into deflation by the end of 2019. Meanwhile, all other core goods categories remained in modest deflation, and if anything dipped further into deflationary territory, all the while core PCE remained at target and even drifted lower. Of course, the potential scale and scope of Trump's latest proposals are much larger than the 2018 experience, but the key points still hold: tariffs represent a one-time price level shift, not a sustained inflationary impulse, and price increases in some categories can translate to demand destruction and lower prices in other categories. That's particularly true in the current environment, where labor slack is slowly building and wage growth continues to decelerate. Those two factors would suggest that the Fed would be better served to look through tariffs unless inflation expectations began to become unanchored – just as the Fed's own 2018 Teal Book suggests. And that's even before considering the potential offsets from a stronger dollar, as well as retaliatory policies that would reduce growth and weigh further on wages and demand. Tariffs will remain a key risk for 2025, but the risks to the Fed's dual mandate aren't as clear, providing further evidence that current rhetoric is offsides.

Source: Portfolio Analysis & Consulting, Bloomberg. FOMC represents Federal Open Market Committee. PCE represents Personal Consumption Expenditures Price Index.

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