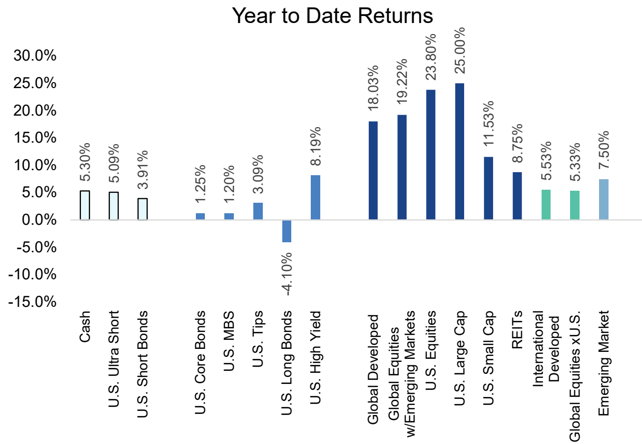
PMA® ASSET MANAGEMENT

Semi-Annual
MARKET OUTLOOK

WINTER 2025

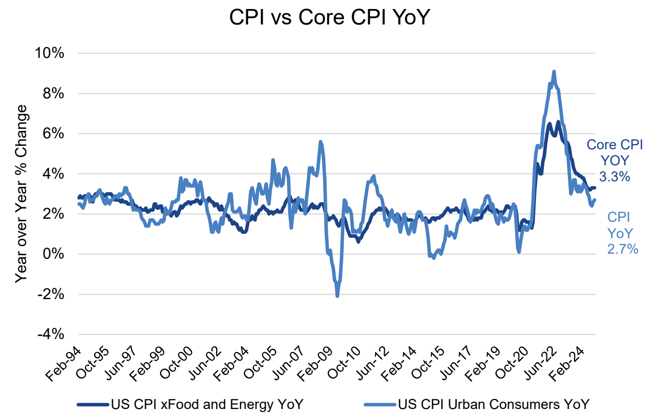
# PMA Market Outlook Summary

Investors enjoyed positive returns during 2024 as solid economic growth and moderate inflation, combined with easier global monetary policies to support risk markets and push asset values higher once again. While our team expects strong returns for bonds and stocks again this year, volatility should remain elevated as fiscal and monetary policy evolve throughout the year under the new presidential administration. With the Fed easing monetary policy by a full 1% since our last outlook, the yield curve is once again positively sloped, and, in our view, rates are relatively attractive. While we forecast cash returns in the 4% range in the year ahead, we expect cash to lag fixed income returns. Fixed income returns are expected in the 4.50-6% range given bonds' income advantage and potential for price appreciation as we forecast slightly lower interest rates in 2025. U.S. Equities should continue to perform well, although with continued higher volatility. We forecast equity returns in the 8-10% range for the year ahead with a much wider distribution of potential returns. Risk management is critical to relative performance in the year ahead, and we continue to emphasize quality and liquidity across our investment strategies.



Source: Bloomberg, PMA Asset Management. Data as of 12/31/2024.

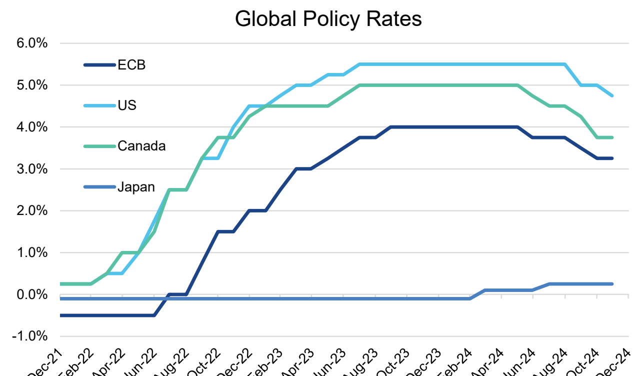
We expect economic and credit fundamentals to remain relatively stable in our forecast, although potential material changes to policy decisions increase uncertainty in our outlook. The risks certainly cut both ways, as trade and geopolitical risks could negatively impact economic fundamentals and the risk of higher inflation, while tax cuts and higher spending could push economic growth higher than expected in 2025. After slowing, and even stalling, declines in year over year inflation prints during most of 2024, inflation has ticked back up during recent months and caused material changes both to Fed policy expectations and the yield curve. While globalization trends were a significant tailwind to deflationary forces over much of this century, deglobalization policies present headwinds to inflation in our view. We see divergent economic and inflation gaps between countries and economic regions causing policy synchronization to fade in 2025. Core inflation measures have ticked back up to 3.3% and, while we expect inflation to modestly recede as we move through the year, potential policy missteps and geopolitical risks create a much wider set of outcomes for inflation. While goods inflation is largely over, service sector inflation remains sticky. We would expect economic growth to slow slightly toward 2% from the most recent 3.1% growth rate we saw in the third quarter of 2024. Consumers are in good shape and the labor market remains healthy. Corporations have improved their financial profiles materially over the past several years as strong earnings growth and debt service coverage is ample.



Source: Bloomberg, Bureau of Labor Statistics, PMA Asset Management. Data as of 11/30/2024.

## Money Market Outlook

If there has been a consistent theme in this economic cycle, it has been that the U.S. economy has remained more resilient than expected and the timing and trajectory of the Fed's easing cycle has been constrained. As we look to 2025, our expectations and outlook for money markets remain the same. While we expect the current market pricing of a Fed in easing mode to remain appropriate, the timing of further rate cuts remains uncertain. Expansionary fiscal policy and sticky inflation will make the path for Fed rate cuts highly data-dependent, with only weakness in the labor market as a potential catalyst for rates to fall further than currently priced. This likely sets up 2025 as another strong year for money market investors as attractive yields make the prospect of investing on the front end of the yield curve attractive from a risk-return perspective.



Source: Bloomberg, Bureau of Labor Statistics, PMA Asset Management. Data as of 12/31/2024.

With our base case expectation of two additional rate cuts this year, record high balances in money market funds will keep demand for treasury bills and dealer repurchase agreement strong, while commercial paper spreads remain attractive relative to fundamentals.

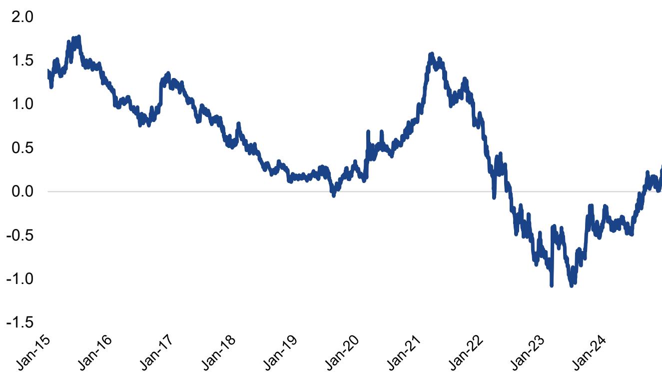
Attractive yields combined with continued balance in money market supply and demand will provide short-term investors with stability, liquidity and attractive risk-adjusted returns throughout the course of 2025.

## Fixed Income Outlook

With the Fed continuing to reduce rates from current restrictive positioning and constructive growth and inflation fundamentals, the forward-looking fixed income risk/return outlook is favorable. The Fed is expected to remain biased to moderate rate cuts over the course of 2025, providing a supportive backdrop to the bond market. While some cuts are priced in, the curve has turned positive, and the market is not reliant on aggressive Fed action. Yields are near 2024's cycle highs and remain attractive relative to history and likely economic conditions. Even as the market contends with uncertainty on several fronts, inflation has peaked. We continue to believe current valuations provide sufficient yield to guide investors to be patiently invested out the curve.

Arguably the most important development in the bond market since our Summer 2024 Outlook has been the normalization of the yield curve. We have finally seen the end of the longest run of an inverted curve in history. The bellwether 2yr-10yr Treasury spread has moved into positive territory since going negative in mid-2022. Most curve segments have moved reliably positive, despite the front-end remaining marginally below the Funds rate. This is an important development on several fronts:

- Represents a more sustainable set of market relationships;
- Promotes stability in financing markets, and;
- Aids market discovery of equilibrium levels and risk premia.




Source: Bloomberg, PMA Asset Management. Data as of 01/06/2025.

It also represents the return of a valuable source of return for intermediate bond investors through positioning for yield curve rolldown and earning increasingly positive yield advantages versus cash markets. While factors such as Treasury supply, fiscal and trade policy, and Fed balance sheet changes all may contribute to volatility in the yield curve, we remain biased for further modest steepening and are positioning portfolios accordingly.

Carry from spread sectors will be an important contributor to expected future returns. Even as spreads are relatively tight, fundamental and technical conditions are generally supportive of spread valuations. This past year saw positive excess returns to spread sectors driven by yield advantage, and from spread compression in the corporate sector. While we are overweight most spread sectors, we are targeting lower spread durations to emphasize higher yield carry per unit of additional risk. We are also selectively reducing our Treasury underweights, as the opportunity cost of holding Treasuries is low. In addition, we have selectively added TIPS at low inflation breakeven levels as an attractive defensive position in portfolios. Quality and liquidity are key considerations at this point in the credit cycle, given tight spreads and the potential for external shocks or policy developments. Commercial real estate and consumer credit remain additional possible wild cards for the bond market.

Corporate credit has benefitted from strong and stable fundamentals in most industries, as well as favorable financial conditions. The corporate sector drove almost all of the positive performance in the bond market in 2024, as spreads tightened to levels not seen since before the Great Financial Crisis and the soft-landing period of the mid-1990s. While 2024 saw the second highest issuance of investment-grade corporates, the market was further supported by heavy investor flows of new money into funds, as well as high demand from foreign investors. At current interest rate levels, we expect continued fund inflows and net new issuance is expected to be lower this year as many issues from 2020 mature. Credit fundamentals in the form of strong cash flow, solid margins, top line growth, and moderate leverage continue to support an overweight to credit. However, we remain vigilant for possible erosion, including M&A risk and pressure for returns to equity. In this environment, credit selection is particularly important. We favor banks, communication, utilities, and technology. We are moving higher in quality and shorter in maturity.

Credit fundamentals and financing conditions also remain supportive of high yield credit. We expect forward default rates to remain low and recoveries to be supported. In the context of overall market risk pricing, high yield remains fair, although we are inclined to reduce overweights opportunistically going forward. We marginally prefer high yield bonds to loans due to quality and structure issues.

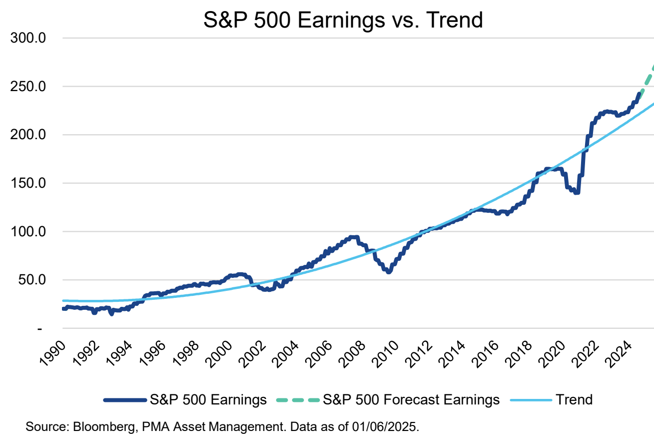
Among securitized and government sectors, we see the best value in high-quality asset-backed securities (ABS) and Agency passthroughs (MBS). ABS remain a high quality, low volatility source of yield advantage with high liquidity. We favor high quality collateral and prime issuers as, despite some consumer pressures, credit performance for these issuers remains solid. Despite outperforming Treasuries, MBS underperformed other spread sectors last year. However, with the rate cycle having turned, the yield curve again positive, and supply/demand technicals improving, MBS is well-positioned heading into 2025. This is particularly true given the strong performance of other sectors. We have been gradually increasing our MBS positioning, focusing on moderately discounted coupons and an emphasis on 15-year MBS. The sector's high-quality and liquidity are also beneficial to portfolios. We are maintaining positions in Agency CMBS for carry and quality, but given strong performance and tight spreads, excess returns are likely to come from carry rather than further spread compression and we are biased to shorter maturities. We prefer these to Agency debentures, which are unattractive.

Municipal credit fundamentals are stable, though headwinds are likely if the economy slows. The market saw record municipal issuance in 2024 as many issuers had capital financing needs that were deferred. The majority of issuance was for new money purposes and was tax-exempt. While net fund inflows helped absorb the additional supply, investor flows are likely to be less supportive this year given policy uncertainty. While increases in the level and cost of services provided may pressure local finances, state and local tax revenues through third quarter 2024 rose year over year for the big four taxes (sales, property, personal income and corporate

income). We remain cautious with smaller or stand-alone healthcare entities (margin pressure risk remains), higher education institutions (more closures possible for credits with weak demand and asset bases), senior living & continuing care/skilled nursing facilities (continued challenges from occupancy levels and staffing shortages), and one-off special service issues. We remain underweight the sector given tight spreads and limited liquidity versus other sectors.

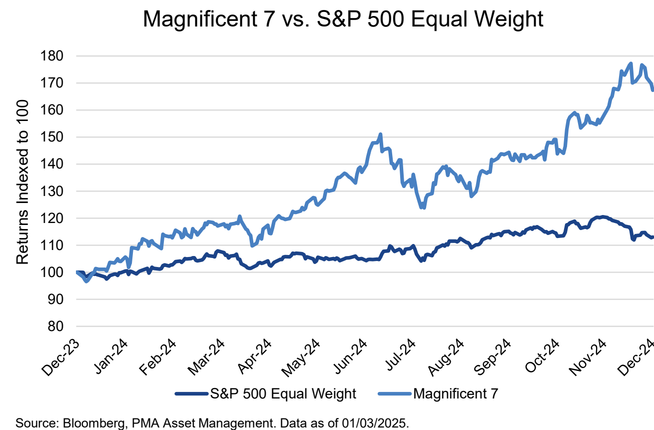
## Equity Outlook

Equity markets did not disappoint investors in 2024 as gains far surpassed our expectations. The median year-end price target for the S&P 500 in January 2024 was only 4,950, indicating a measly 3.8% price return. Fast forward to the final day of December and the index closed at 5,881.63 and a total return of 25%. The S&P 500 notched back-to-back 20%+ returns in 2023 and 2024, for the first time since a streak of five such years from 1995-1999. The NASDAQ Composite did even better, with a total return of 29.6%. Small capitalization stocks started the year poorly, lagging large capitalization by the most on record through the first six months of a new year. However, a second half rally based on lower rates and the election outcome supported the Russell 2000 to a gain of 11.5%.




Source: Bloomberg, PMA Asset Management. Data as of 01/06/2025.

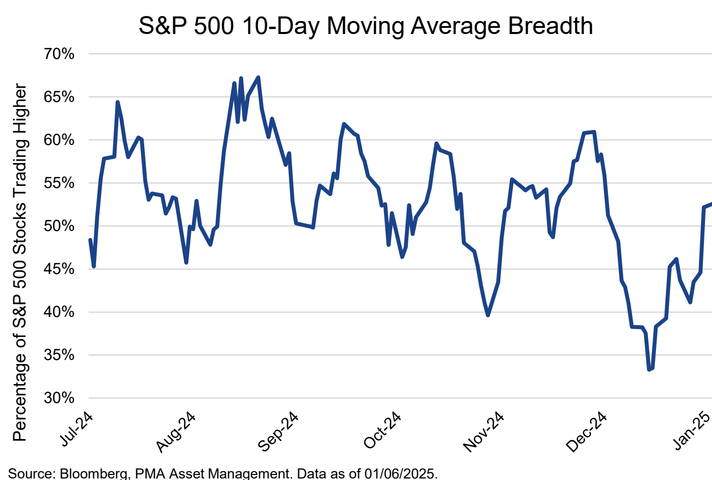
During much of the year, exuberance surrounding mega cap tech and AI fueled gains for the Magnificent 7 as well as any sector or stock that could benefit from secondary demand. While the second half of the year was characterized by a low-quality rally driven by improving economic data, lower inflation, and a greater probability of lower rates.




Source: Bloomberg, PMA Asset Management. Data as of 01/03/2025.

However, weak breadth returned in the final month of the year and the Magnificent 7 accounted for 53.4% of the year's total return, while Nvidia alone accounted for 21.6% of the total return. While other strategists and advisors continue to ring alarm bells about the high concentration of returns and weak breadth, we are relatively less concerned. The underperformers which have led to poor breadth are just as likely to "catch-up" as it is for the top-performers to "catch-down." In fact, weak breadth has led to gains more often. Additionally, we see supportive behavior from the bottom 493 stocks in the way of earnings growth. The bottom 493 stocks are expected to grow 2025 earnings at a 13% clip. This is significantly higher than the 4% growth forecasted for 2024.

Looking forward to 2025, we believe solid returns are likely, though we would not be surprised if equities experienced volatility on their way. Several factors could lead to disruption, which include historically high valuations, weak breadth, seasonally higher volatility, and policy uncertainty as the new administration begins to roll out priorities. That said, we think equity returns remain strong given positive earnings growth estimates at 10% and 13% for 2024 and 2025, respectively.




Source: Bloomberg, PMA Asset Management. Data as of 01/06/2025.

Increasing earnings breadth and $1 trillion in estimated buybacks should also support earnings. Additionally, the Magnificent 7 are expected to increase earnings by 21%, which we view as a durable estimate given their large backlogs and recurring revenues. Further, multiples could remain flat or only marginally lower. Rates remain on a lower trajectory, which is supportive of valuation multiples. We also see a possibility that increased productivity and growth gains are driven by AI, ultimately helping support multiples. Finally, structural changes over the last several years support multiples settling at a higher level than the 18x P/E the S&P 500 averaged over the last 20 years. The Magnificent 7 account for 28% of the S&P 500 with a median P/E of 36x. That changes the math for the S&P 500 multiple significantly. With the above in mind, we expect S&P 500 earnings to be $260 per share, marginally lower than consensus. We also expect P/E to remain steady, with just a slight drop to 24.5x from ~25x at the end of 2024. This implies a total return in the 8-10% as a base case in 2025.

Political risks are currently quite elevated, both domestically and internationally, but we believe that increased policy clarity should come throughout the year. This should help drive private investment, but headline volatility is likely as the year goes on. In periods of volatility, keeping the big picture in mind will be of great importance. It has been frequently noted that many Trump policies, most notably tariffs, would stoke inflation. However, we expect stock market gains to rank of higher importance to the new administration.

We therefore view policies that would impose negative outcomes on equity prices to be more likely as bargaining chips than actual policy plans. Nonetheless, policy uncertainty should not be overlooked, as recent history teaches us that previously unexpected outcomes are increasing in frequency.

We continue to prefer U.S. equities compared to foreign as we expect U.S. exceptionalism to continue, with secular growth opportunities, higher quality companies, as well as stronger U.S. GDP growth. Foreign companies also exhibit much weaker growth clarity, which is noted by analysts' weaker ability to forecast individual results, frequently overshooting actual sales and earnings. A final point of caution on foreign stocks is that both geopolitical and domestic political issues have been flaring for several years and have recently ramped with issues in South Korea, France, and Syria. A potential tailwind for developed international equities is exposure to stocks with high dividend yields, which may benefit from inflows as rates continue a trend lower.

We believe that both large and small capitalization stocks can perform well in 2025. Large capitalization stocks should continue to benefit from secular growth, durable estimates, and strong execution and management teams. Small capitalization stocks have renewed opportunities, in our opinion. The S&P 600 is currently 40% cheaper than the S&P 500, a discount level that tends to lead to positive small capitalization performance. Additionally, lower rates, protectionist U.S. policies, and surging small business sentiment should all help support small companies. While we have noted that rates are trending lower, they may settle at a higher terminal rate than recently projected. This, combined with a recent low-quality rally, leads us to believe that high quality stocks should see outperformance relative to low quality in 2025. Valuations for both the growth and value factor groups are historically high. Value trades at a 10% premium since 1995, while growth appears much worse at a 39% premium. However, as discussed, we continue to prefer the growth factor given its higher quality, secular growth, earnings clarity, and management execution.

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