# Market and Economic Review

Client Communication for the Fourth Quarter 2024

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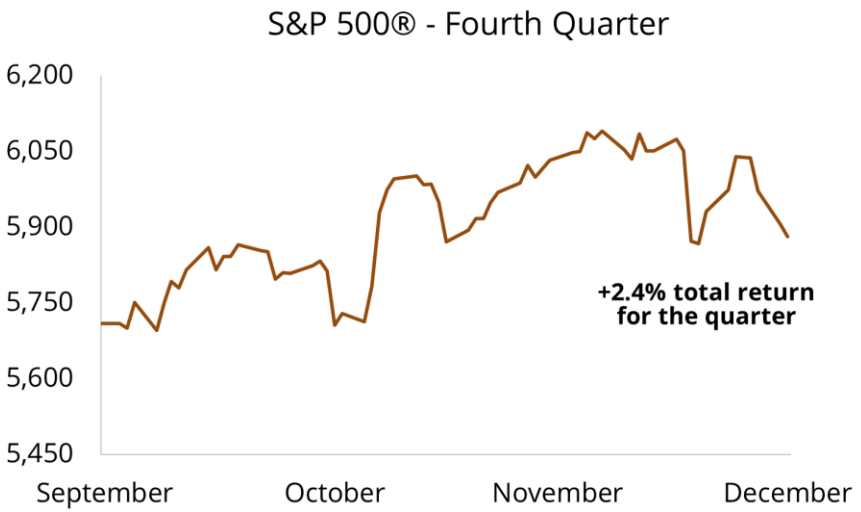
# 4Q 2024 - Another Solid Quarter

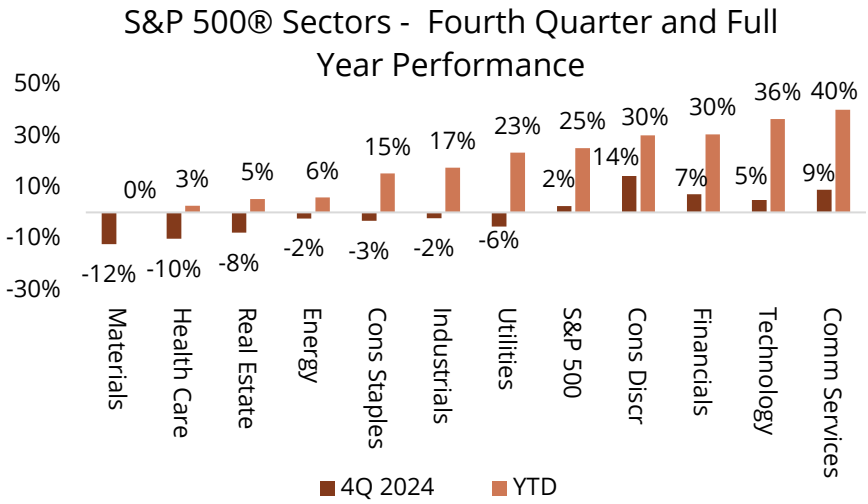
## Fourth Quarter Highlights

Equity markets continued to move higher in the fourth quarter, up 2.4%, bringing the year-to-date return to an impressive 25.0%, the second consecutive year above 20%.

The Federal Reserve (Fed) continued to reduce the policy rate during the quarter, delivering -0.25% reductions in both November and December while not making any adjustments to their balance sheet runoff.

GDP growth has remained solid with expectations for 2.4% GDP growth in 4Q and 2.1% in 2025. We are awaiting the arrival of the new administration which will influence economic growth and inflation in 2025.



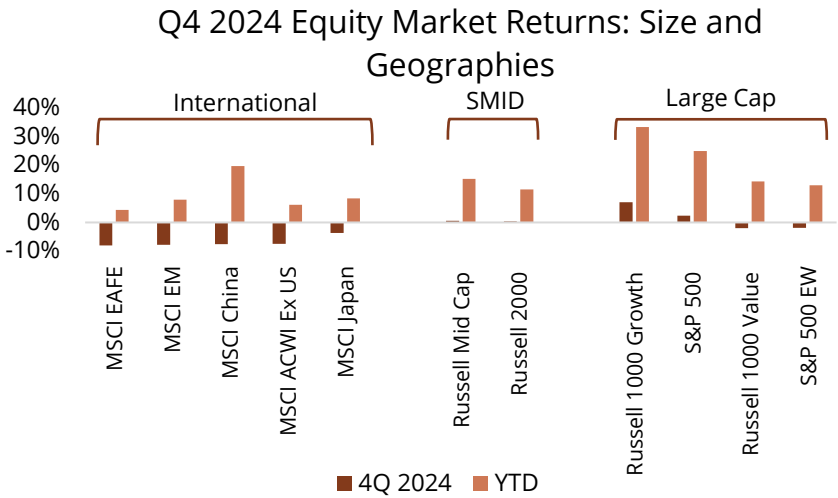

## Sector Snapshot

While the S&P 500 index capped off an impressive year in the fourth quarter, sector performance was mixed. Consumer Discretionary, Communication Services, Financials and Technology had positive returns while the other sectors ended the quarter in negative territory.

For the full year, Communication Services, Technology, Consumer Discretionary, Financials and Utilities all had 20%+ returns. Materials was the worst performing sector, posting a -12% return in the fourth quarter and flat performance for the full year.

Sources: FactSet, Bloomberg, Madison Investments

# A Familiar Story in 2024

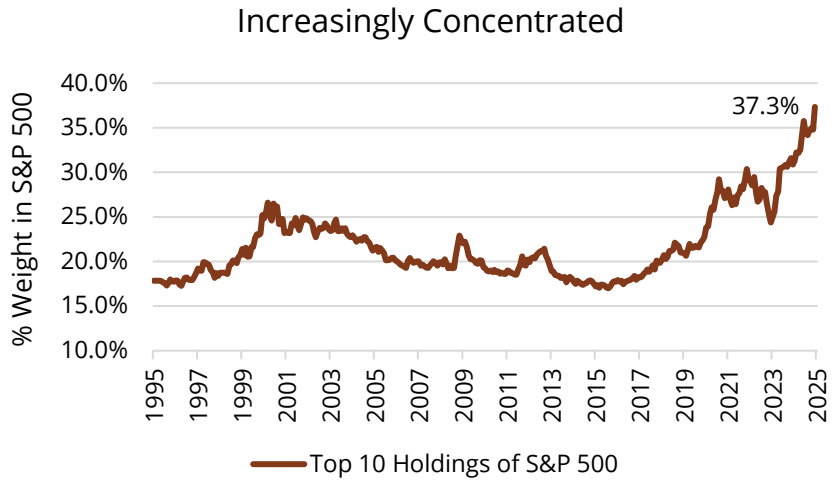



## Familiar Story

Much of the story driving equity returns in the fourth quarter, and last year, is a familiar one: US over international, growth over value, and large caps over mid- and small caps.

The equal-weighted S&P 500 was down -1.9% in the fourth quarter and up 13.0% for the year relative to the market cap weighted S&P 500 which was up much greater 25.0%.

The threat of tariffs emerging post the US election and a strengthening US dollar weighed on non-US assets into year end.




## Opportunities

The market remained narrow in 2024.

After such an impressive run by a handful of the largest companies, the market has become increasingly concentrated with the ten largest companies in the S&P 500, combining to represent 37.3% of the index.

We believe that 2025 will have similarities to 2024, however, we anticipate that the most rewarding opportunities in US equities will be outside of traditional market cap weighted indices, creating an environment that should be rewarding for active managers.

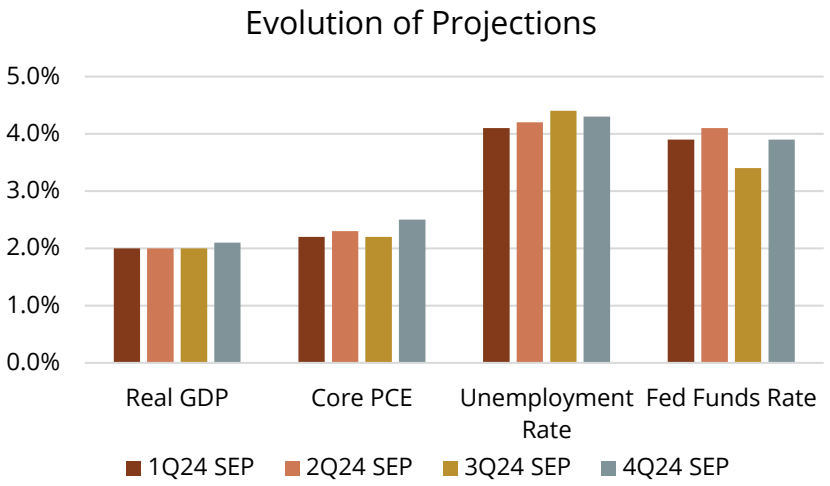
Sources: Morningstar Direct, Factset, Madison Investments

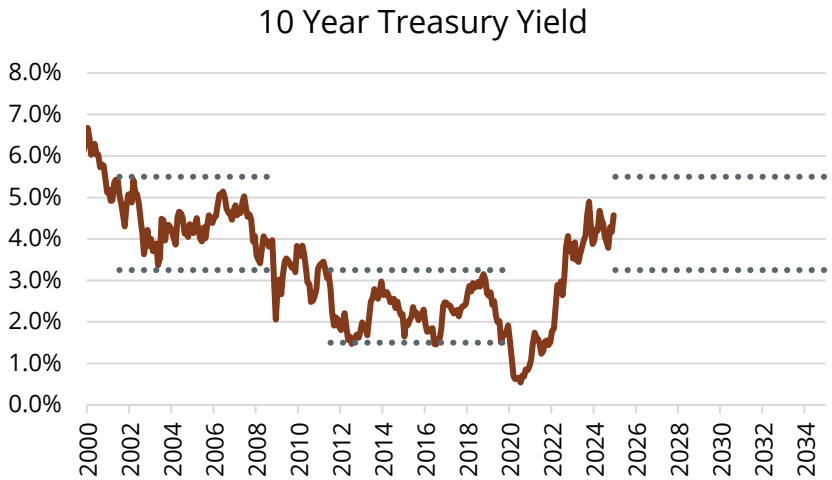
# Interest Rates – Anticipating Fewer Cuts

## Projecting Fewer Rate Cuts

The Federal Reserve (Fed) ended the year with the policy rate at a target range of 4.25% to 4.50% after reducing the policy rate three times, starting in September with a large -50 basis point (bps) reduction, followed by "normal" -25bps reductions in both November and December.

The Fed also released their latest Summary of Economic Projections (SEP) which indicated that members of the Federal Open Market Committee (FOMC) are now projecting a more shallow rate cutting cycle as they revised their inflation (Core PCE) estimate higher.




## Structurally Higher Rates

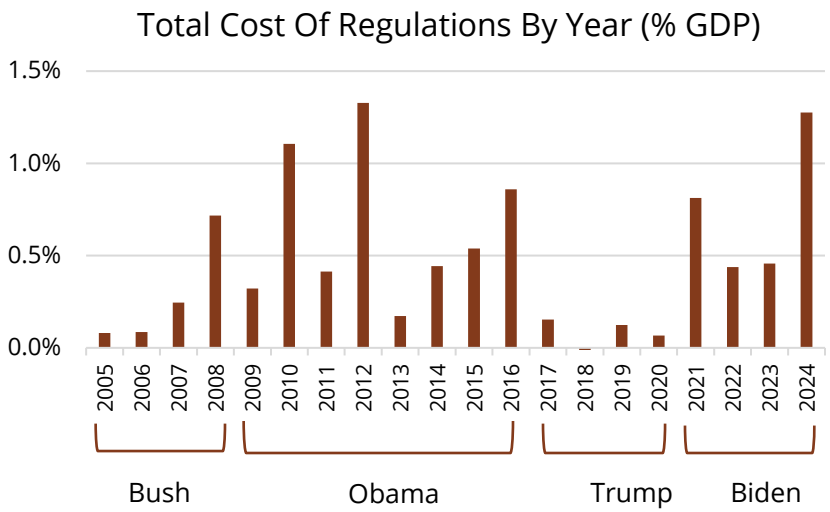
While short-term interest rates will be largely dependent upon the Fed's actions, the path for longer-term rates isn't as clear.

Since the Fed began their easing cycle in September, the bellwether 10-year Treasury yield increased by nearly a full percentage point, ending the year at 4.57%.

With economic growth remaining strong, and inflation appearing to settle in above the Fed's 2% price stability target, we believe we are entering an environment that will have structurally higher interest rates, similar to the range experienced in the early to mid-2000s.

Sources: Factset, Federal Reserve Bank, Madison Investments

# Trump Policy 2.0




## Deregulation

The ultimate policies that will be implemented by the incoming administration are unknown at this time, but we can look to the previous term in office to better understand the direction of policy.

Regulatory costs during President Trump's first term were materially lower than under both President Obama and President Biden.

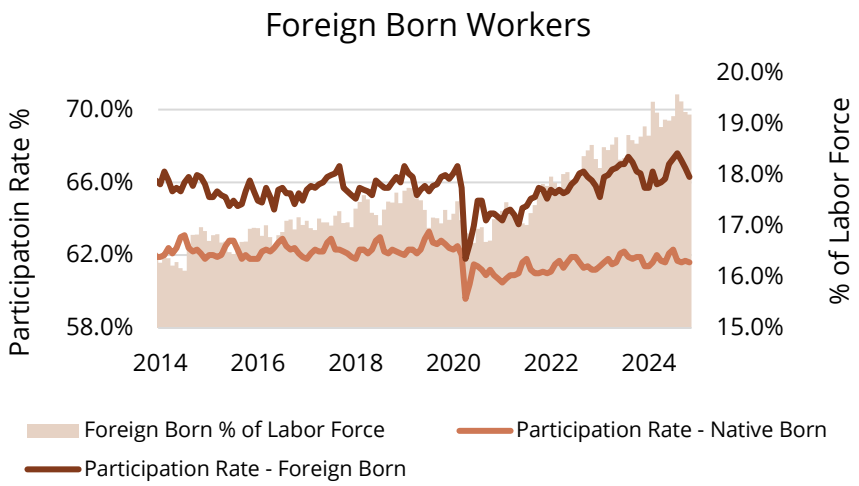
Overall, we believe that the regulatory burden will be lower in 2025 and the years ahead which will be incrementally positive for the US economy and corporate profits.

## Immigration Policy

Another area that the incoming administration campaigned on, and has a very different approach than the current administration, is immigration policy.

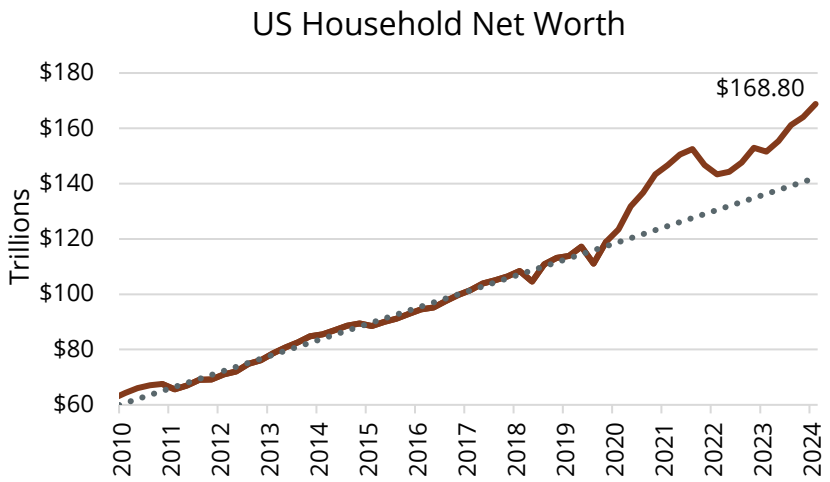
Over the last four years, foreign born workers have been playing an increasingly larger part in the US labor market, representing nearly 20% of the total labor force today.

Should immigration slow or mass deportations be implemented, it could be detrimental to the US labor force and have negative implications for economic growth and inflation.




Sources: Doug Holtz-Eakin, American Action Forum, Piper Sandler, Federal Reserve Bank of St. Louis, Madison Investments

# Consumer Feeling Better

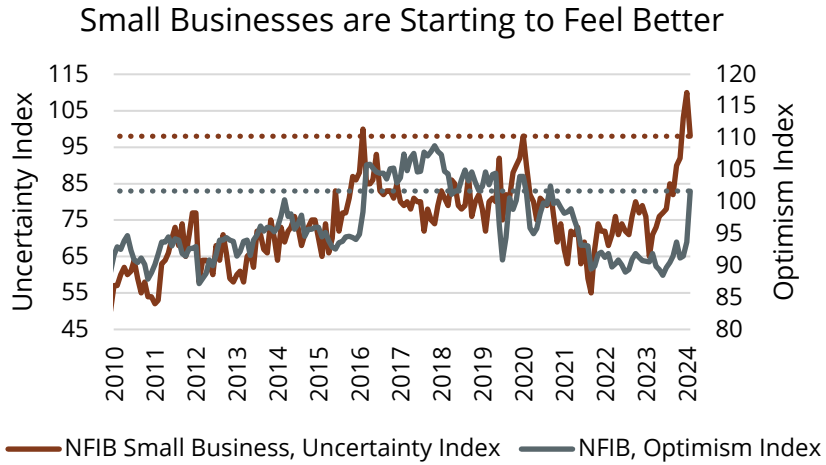



## The Wealth Effect

A combination of strong equity markets and unique housing market dynamics have contributed to household net worth continuing to move above its pre-pandemic trend level.

This increase lends itself to a positive wealth effect that supports consumer optimism and spending, which in turn helps support economic growth.

A material decline in net worth could have the opposite effect in which consumers begin to tighten their belts. Given the structural dynamics of the housing market, we don't anticipate any material weakness here, however, it could appear in the equity market.




## Feeling Optimistic

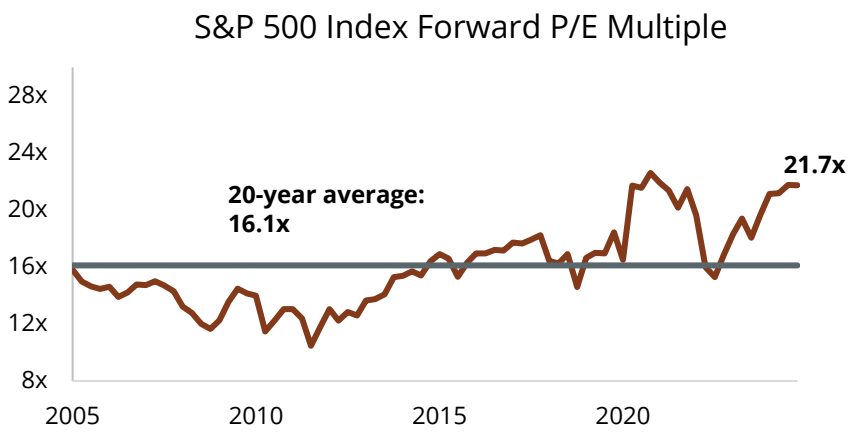
The post-election environment has seen a positive shift in small business sentiment.

This is an encouraging development as prior to this improvement, sentiment amongst small business operators was languishing and ahead of the election, uncertainty among the group hit a record high.

Since November, optimism has improved and uncertainty has begun to recede, which will likely lend itself to increased investment (capital expenditures) and more robust hiring plans, an incremental positive for economic growth.

Sources: Factset, Madison Investments

# Another Positive Quarter for Markets, Valuation Remains Above Average




**(Top Left)** With another solid market move in the fourth quarter, valuations have again pushed higher, reaching 21.7x forward earnings. This is well above the 20-year average of 16.1x. However, the equal-weighted S&P 500 forward P/E multiple is just slightly above its long-term average, which implies that there are a handful of stocks with very high earnings multiples while many at less demanding and more attractive valuations.

**(Bottom Left)** After two consecutive years of below average earnings growth in 2022 and 2023, consensus expectations are for earnings growth in 2024 of around 9% with estimates for 2025 expected to grow at 13%.

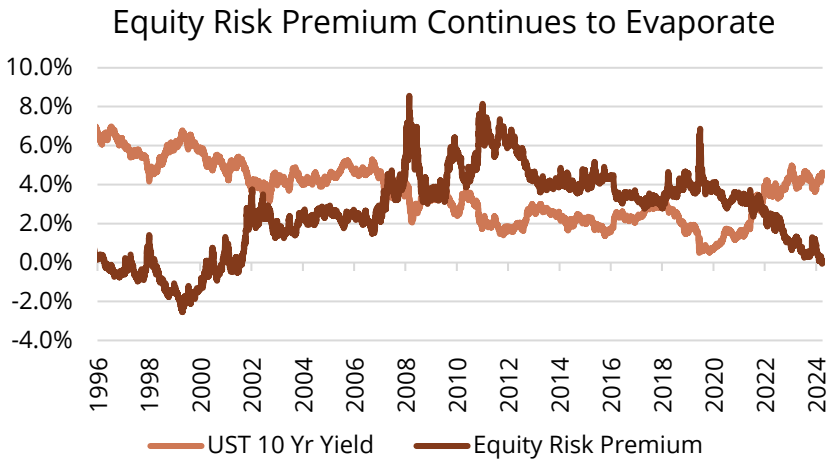
**(Bottom Right)** As multiples continued to expand in 2024 and interest rates moved higher, equity risk premium continued to deteriorate. While this makes fixed income continue to look relatively more attractive than equities, we would note that the equity risk premium can continue to go lower (equities can continue to do well) as they did in the late 1990s as the equity risk premium remained negative.

## S&P 500 Level Implied by Price to Earnings Combinations

| S&P 500 Earnings per Share | Price/Earnings Multiple | | | | | |
|---|---|---|---|---|---|---|
| | 14x | 16x | 18x | 20x | 22x | 24x |
| $325 | 4,550 | 5,200 | 5,850 | 6,500 | 7,150 | 7,800 |
| $312 | 4,368 | 4,992 | 5,616 | 6,240 | 6,864 | 7,488 |
| $300 | 4,200 | 4,800 | 5,400 | 6,000 | 6,600 | 7,200 |
| $275 | 3,850 | 4,400 | 4,950 | 5,500 | 6,050 | 6,600 |
| $260 | 3,640 | 4,160 | 4,680 | 5,200 | 5,720 | 6,240 |
| $248 | 3,472 | 3,968 | 4,464 | 4,960 | 5,456 | 5,952 |
| $240 | 3,360 | 3,840 | 4,320 | 4,800 | 5,280 | 5,760 |
| $230 | 3,220 | 3,680 | 4,140 | 4,600 | 5,060 | 5,520 |

| S&P 500 Top Down Estimates | | |
|---|---|---|
| | Mean | Growth |
| 2022A | $219.19 | 5.1% |
| 2023A | $221.44 | 0.5% |
| 2024E | $242.00 | 9.3% |
| 2025E | $274.00 | 13.2% |
| 2026E | $318.50 | 16.2% |

Sources: Factset, Bloomberg, Madison Investments



# Fixed Income Executive Summary

## Market Summary (4Q24)

- Interest rates shifted abruptly higher during the fourth quarter as investors adjusted outlooks in response to economic conditions, election results, and Fed policy.
- The U.S. economy expanded 3.1% during the third quarter, supported by personal consumption and government spending. The unemployment rate ticked 0.1% higher to 4.2%, a reflection of layoffs as well as job seekers reentering the workforce.
- The latest Consumer price reading (CPI) rose to 2.7% in November, up from 2.4% in September. The rolling 3-month annualized rate for service sector inflation is above 4% while the comparable durable goods inflation rate moved above 5%.
- Treasury yields shifted in response to both Fed policy and investor views. Treasury yields for 3-month, 2-year, and 10-year maturities changed by -1.02%, -0.01%, and +0.69%, respectively.
- During the quarter, A-rated corporate bond spreads fell by 5 basis points (bps) while BBB-rated spreads dropped by 14 bps. The average spread on corporate bonds fell 9 bps to 73 bps.

## Matters Madison Fixed Income Are Monitoring

- The resilient U.S. economy has seemingly led the Fed towards recalibrating the pace of future rate cuts. Barring economic or financial market upset, investors now anticipate the Fed will cut rates only twice in 2025, reducing the federal funds rate by 50 basis points to 4.00%. Policies employed by the incoming administration are apt to influence growth prospects, although it's difficult to forecast possible ramifications.
- Overall, the financial condition of households remains secure given favorable employment conditions, wage gains, and ability to borrow. However, some in lower income brackets are struggling to pay bills and beginning to default on debt. A rise in inflation or ill-intended consequences of aggressive tariffs could stress an increased number of households, thereby reducing consumption and compounding consumer credit defaults.
- Corporate bond spreads appear too low given market uncertainties. Currently, asset-backed and mortgage-backed securities could be a viable alternative.

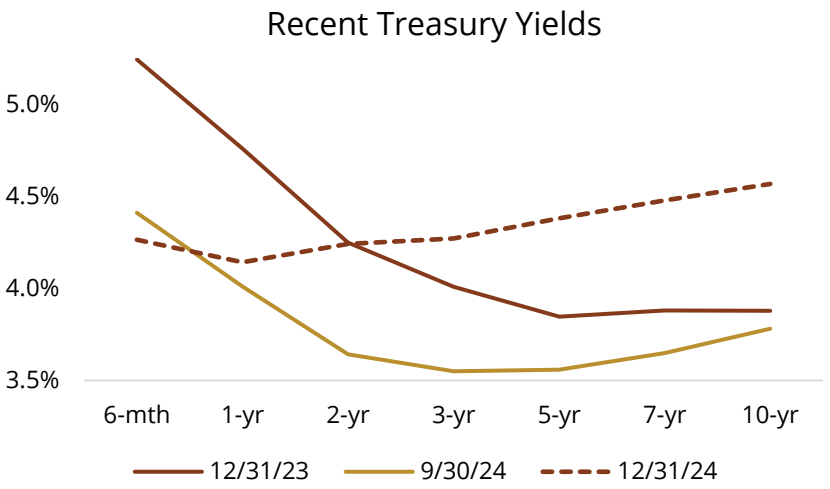
Source: Madison, Bloomberg, ICE Global Indices

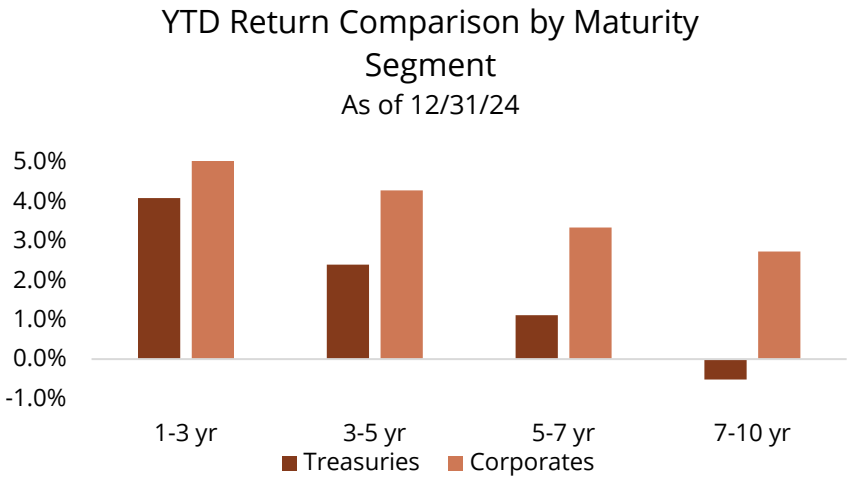
# 4Q 2024 – Fixed Income Attribution

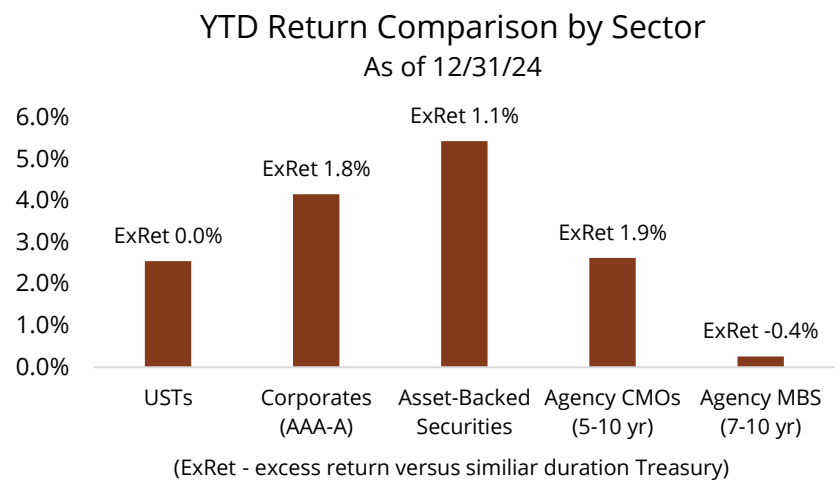
## Attribution Comments

Intermediate investment grade bonds posted negative returns during the fourth quarter as interest rates adjusted higher in response to the Federal Reserve's policy stance. The Treasury curve (shown at right) steepened during the quarter as yields beyond a year moved higher in anticipation the Fed will lower rates less than expected during 2025.

For the full year, bond returns were influenced by yield curve positioning and sector selection. Shorter-dated bonds (shown lower left) posted higher returns than longer-dated paper. From a sector perspective, corporate bonds, asset-backed securities, and agency collateralized mortgage obligation generated better returns than similar maturity Treasuries.



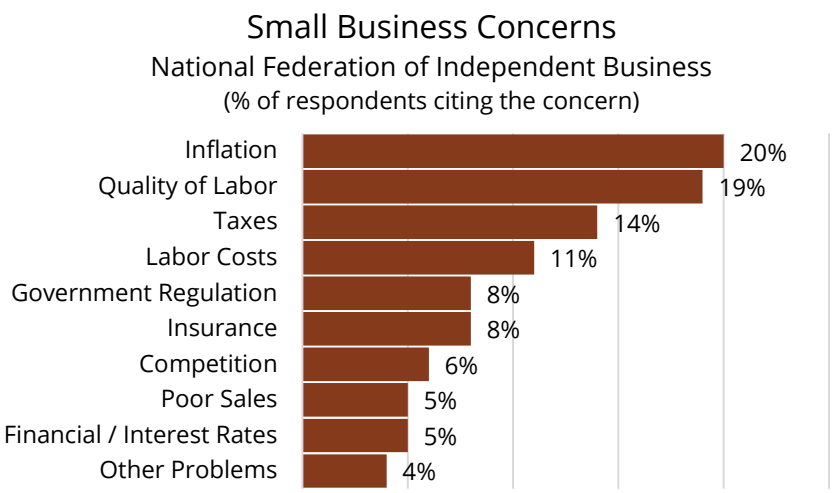



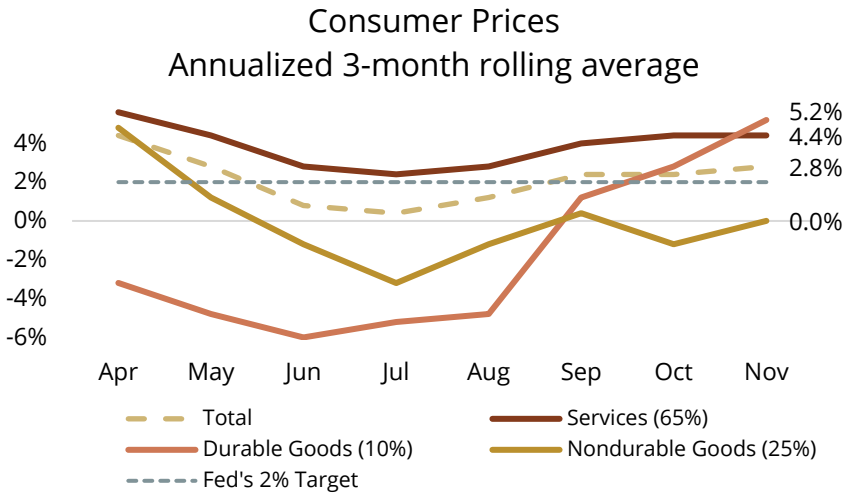

Source: Madison, Bloomberg, ICE Global Indices

## Small Business Optimism Shifts Higher

At the end of November, the National Federation of Independent Business reported its index gauging small business optimism jumped from 93.7 to 101.7, the first reading above 100 since mid-2021. The rosier outlook for general business conditions were undoubtedly influenced by election results given prospects for increased protectionism measures, less regulation, and tax stability.

Small business leaders, however, remain concerned about factors that could disrupt economic growth and company profitability including inflation, labor quality, taxes, and labor costs.




## Inflation is Proving Difficult to Tame

Consumer prices fell during the first 9 months of 2024 before nudging higher during the latter 3 months of the year. Inflation within the Services sector remains above 4%, troublesome given the sector accounts for 65% of the Consumer Price Index (CPI).

Worrisome is the fact durable goods prices recently increased at an annualized rate above 5%. Given 75% of CPI components are currently rising at an annualized rate above 4%, the Fed may find it increasingly difficult to reach its 2% inflation target over the near-term.

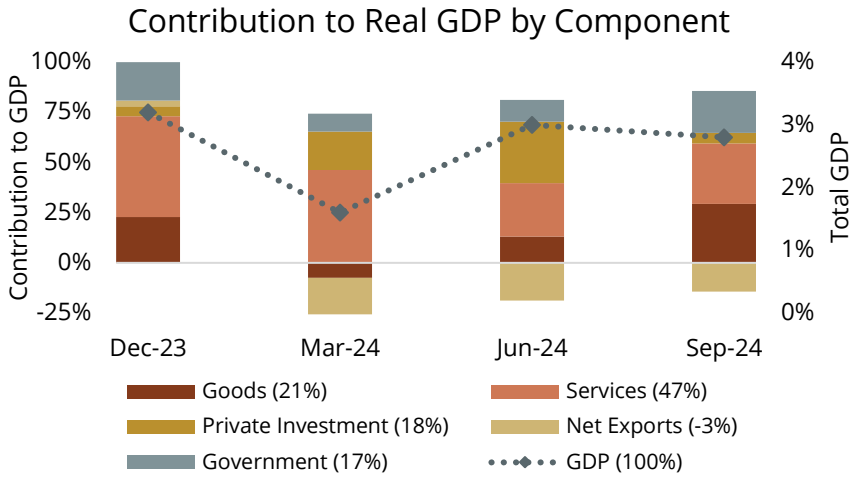
Source: Madison, Bloomberg

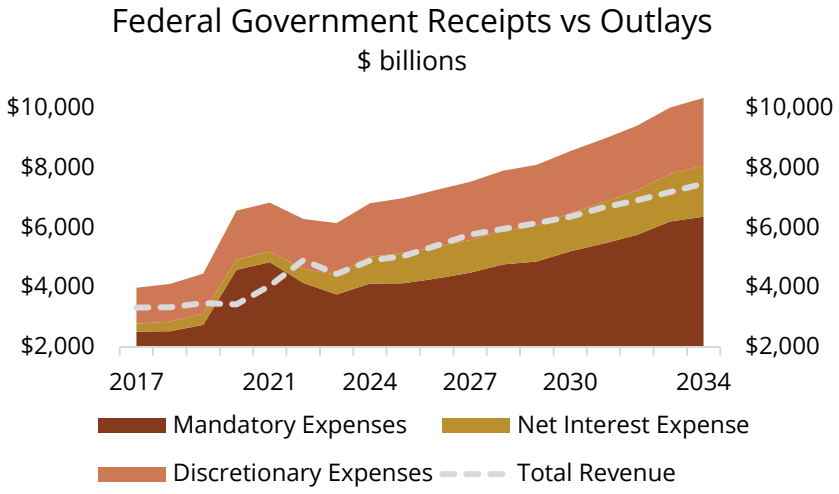
# Macro Commentary

## The U.S. Economy Continues to Expand

GDP expanded 3.1% during the third quarter and economists (on average) project 2.3% growth during the fourth quarter. The chart at right shows that Goods, Services, and Government spending have been positive contributors to overall growth during the past two quarters while net exports have been a small drag.

While economic growth is typically positive for our country, we're concerned that amplified consumption of goods and services may contribute towards stickier or higher prices in the short-run for both individuals and businesses. Moreover, an intensified use of tariffs could promote inflation, strain business profitability, and potentially slow economic growth.




## Interest Rates Could be Impacted by the Federal Deficits

| % of Total Federal Outlays | 2017 | 2024 | 2034 |
|---|---|---|---|
| Mandatory | 63% | 61% | 62% |
| Discretionary | 30% | 26% | 22% |
| Net Interest | 7% | 13% | 17% |

The U.S. federal debt burden continues to swell as annual spending exceeds receipts. Net interest owed on outstanding U.S. debt (as a percentage of total federal outlays) increased from 7% in 2017 to 13% in 2024. The Congressional Budget Office projects this line item could reach 17% by 2034. We believe interest rates may adjust upward over time should U.S. debt be unrestrained.

Source: Madison, Bloomberg

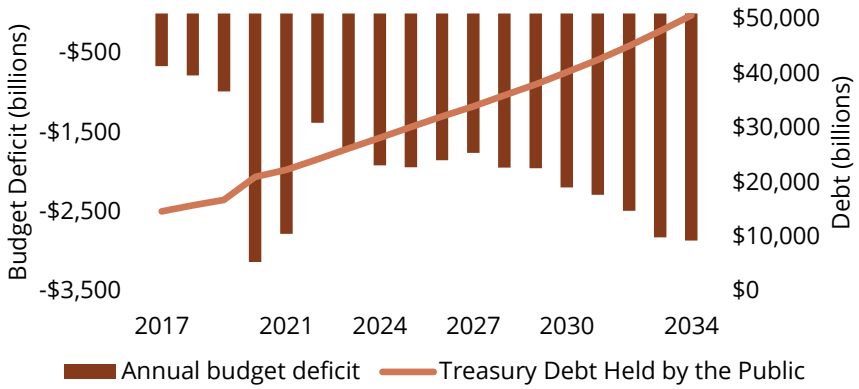
# Asset Class (Governments)

## Federal Budget Deficit and U.S. Debt Burden

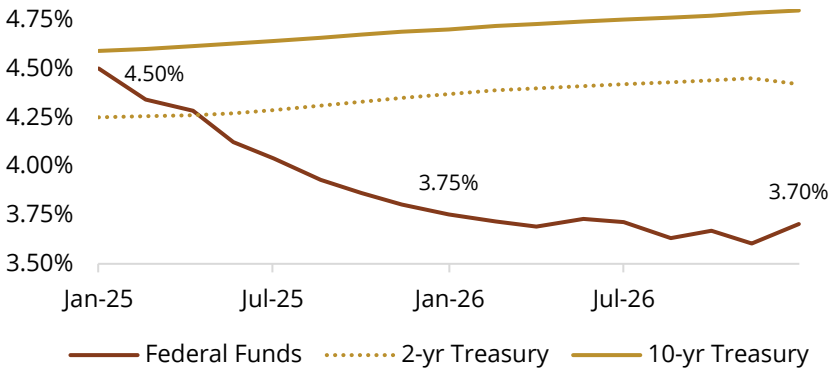
Annual federal budget deficits became commonplace in the early 2000s and were magnified during the 2008-2009 financial crisis. Beginning in 2019, deficit spending has ranged from $1.0 trillion to $2.8 trillion per year. During this period, federal debt held by the public (which excludes debt held by the Fed) increased from $23 trillion to $34 trillion at year-end 2023.

Of concern is the enlarged debt service burden which could inflate deficits as greater interest expense becomes a significant budget consideration. Although U.S. rates are generally influenced by macroeconomics, it's conceivable weaker federal government creditworthiness could push interest rates upward.

Federal Budget Deficit and
Treasury Debt Held by Public




Market Expectations for Interest Rates
(based on the interest rate futures)




Source: Madison, Bloomberg

## Prospective 2025 Federal Rate Cuts

Expectations for the Fed to lower the federal funds rate to 3.75% by year-end 2024 did not materialize as the U.S. economy sustained its growth trajectory, employment conditions remained intact, and inflation endured above the Fed's 2% target.

Market participants currently project a 4.00% federal funds rate by yearend 2025, in contrast to September when the projection was 3.00%. Given our growth expectations and inflation outlook, we believe short term rates will finish 2025 at 4.00%. We also believe longer term rates will be range bound, although there will likely be episodes of volatility. Such instability may provide opportunities to reposition portfolios.

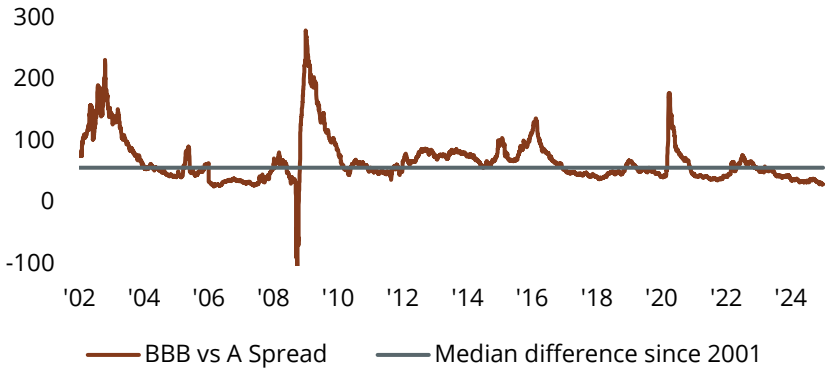
# Asset Class (Corporates)

## Risk Premiums Reflect a Positive Credit Environment

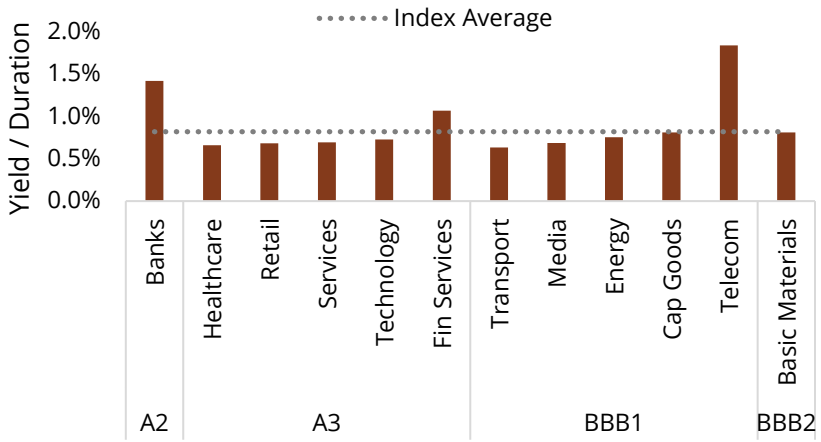
Investor demand for corporate bonds persisted during the fourth quarter with the average spread ending the year at 73 bps, a contraction of 9 bps since September and a 19 bps decline for the year.

While credit metrics are positive for many corporate issuers, we are mindful of the potential for risk premiums to widen should the economy falter. As shown at right, the spread difference between BBB-rated and A-rated bonds continues to be below the historic median, a sign the average BBB-rated bond may be overvalued. Though we continue to position corporate bonds, our emphasis is on high quality credits within less volatile industries.

Spread Difference between
BBB-rated and A-rated Corporate Bonds




Corporate Bond Breakeven Yields




## Breakeven Yields are Low for Most Industries

Breakeven yields for most corporate bond sectors are currently below the index average. This even holds true for BBB-rated sectors, the exception being Telecom.

We believe the best relative value is within the Financial sector (i.e. Banks and Financial Services) as evidenced by both the sector's quality and higher breakeven yields. During the fourth quarter, rating agencies upgraded a few banks due to improved creditworthiness. Barring a change in the U.S. economic outlook, we plan to add to certain financial names.

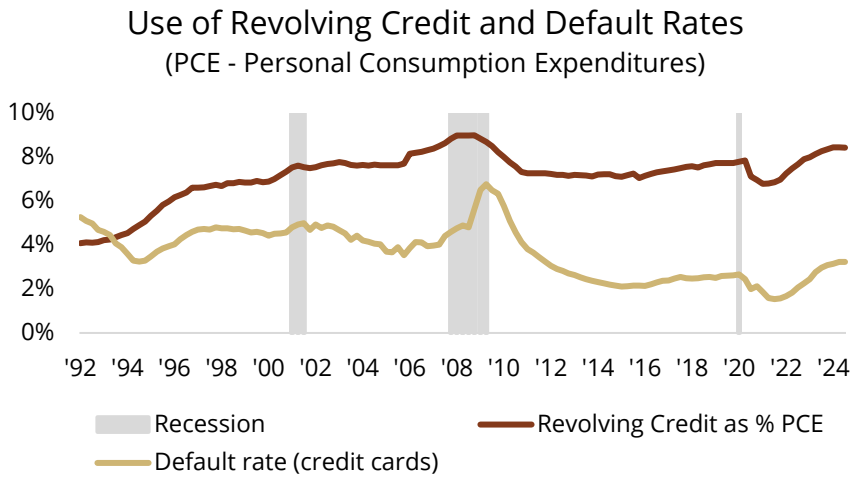
Source: Madison, Bloomberg, ICE Global Indices

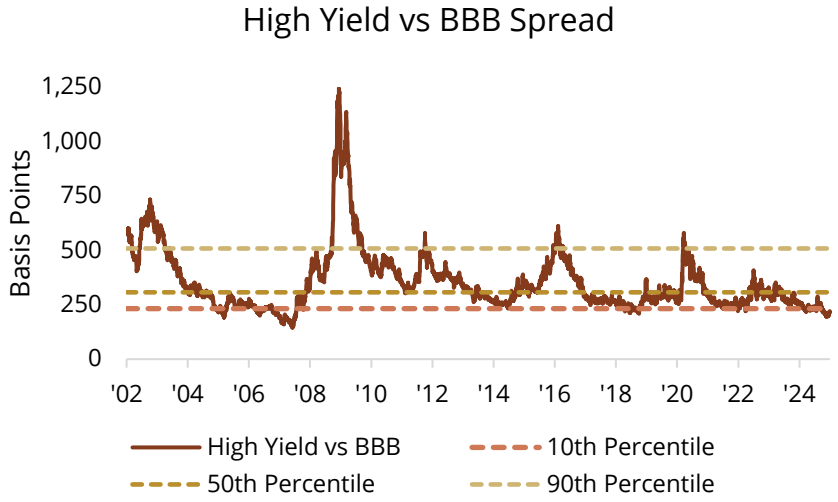
# Asset Class (ABS/MBS & High Yield)

## Use of Credit Card Debt is on the Rise

Some households are running low on cash and turning to credit cards to finance purchases. A few consumers have become unemployed while others are unable to maintain their desired standard of living despite wage gains. As a percentage of Personal Consumption Expenditures (PCE), the current use of revolving credit has not been this high since 2009.

The increased use of revolving debt typically results in an uptick in the rate of credit card defaults. This parallel also extends to non-revolving debt such as auto loans and home loans. While asset-backed valuations are currently attractive, our focus is on well-structured deals with ample credit protection.



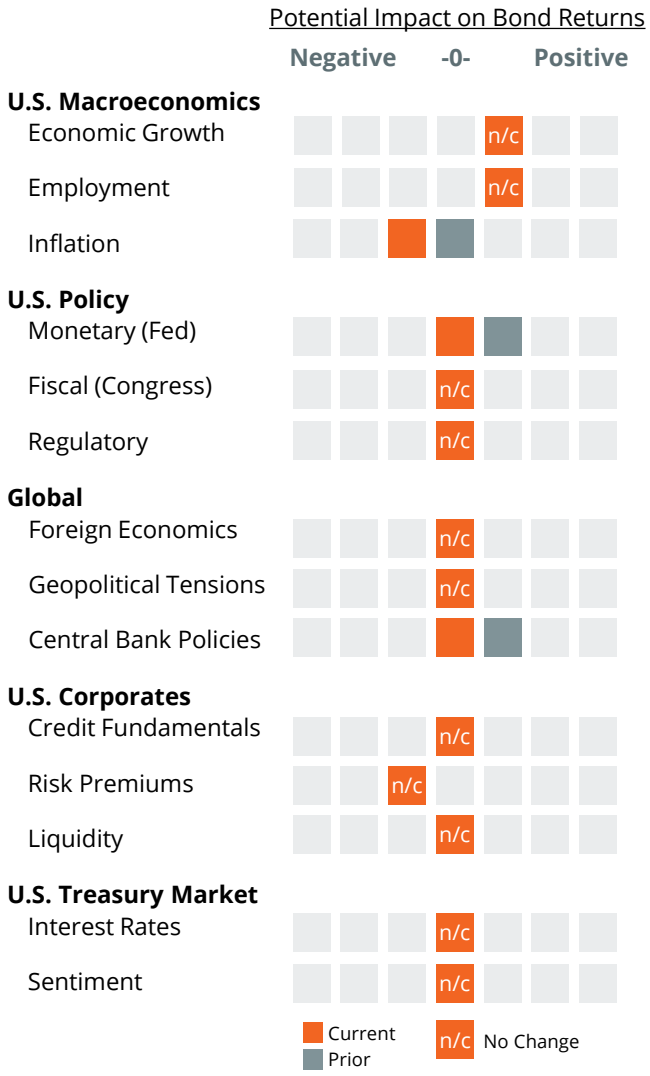

Source: Madison, Bloomberg, ICE Global Indices

## Below Investment Grade Bonds Appear Overvalued

High yield bond spreads often shift in response to liquidity events and credit trends. Currently, the average high yield bond spread is 310 bp which is 217 bps higher than the average BBB-rated bond. The spread difference falls into the fifth percentile which means the spread difference has been higher than 217 bps 95% of the time since 2001. It seems high yield bonds are currently priced for an extended period of financial stability.

In recent months, default rates have moved higher while economic uncertainties have escalated due to Fed policy and ambiguities related to the incoming administration. Despite favorable high yield performance in recent months, we believe other fixed income sectors offer more attractive value.

# Fixed Income Scorecard




Economists are forecasting GDP to decline towards 2%, with little concern about a possible recession. Layoffs are expected to continue, although unemployment is unlikely to move much higher than 4.2%. Recent reports show inflation inching upward, the result of sticky Service sector prices and acceleration of durable goods inflation.

Recent Fed comments suggest the central bank will likely cut rates by less than initially projected. Market participants now expect rates to decline by 50 bps during 2025. The incoming administration and Republican controlled Congress are prone to expand fiscal spending and undertake regulatory changes, although it's too early to predict outcomes.

World economies are forecast to grow 3.0% in 2025 and 2.9% in 2026. U.S. dollar strength and implications of prospective U.S. tariffs could impact international growth to the downside. Mounting global tensions could influence demand for safe-haven assets such as U.S. Treasuries.

Corporate creditworthiness remains solid for most investment grade issuers. In contrast, some high yield issuers have struggled to service debt and declared bankruptcy. Credit spreads look minimal given both economic and political uncertainties, especially for lower quality issuers. We believe an up-in-quality bias is prudent at this point in the credit cycle.

The Treasury curve has shifted to a more positive shape with absolute yields now appearing to offer much better value than three months ago. The demand for U.S. sovereign debt is prone to change in response to Fed policy, the outlook for inflation, and the level of outstanding U.S. debt.

Source: Madison

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# Definitions

**A basis point** is one hundredth of a percent.

**Yield Curve** is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward sloping curve), inverted (downward sloping curve) and flat.

**Bond Spread** is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

**Income from tax-exempt bonds** may be subject to the federal Alternative Minimum Tax and state and municipal taxes.

**Federal funds rate** is the target interest rate range set by the Federal Open Market Committee (FOMC) for banks to lend or borrow excess reserves overnight. It influences monetary and financial conditions, short-term interest rates, and the stock market.

**Option-adjusted spread** (OAS) measures the difference in yield between a bond with an embedded option (e.g. callable bonds, mortgage-backed securities) with the yield on Treasuries.

**Percentile Rank** is a statistical measure that indicates the relative standing of a value within a dataset. As an example, a sector with an OAS of 35 and a percentile rank of 25 indicates that historically the OAS has been below 35 twenty-five percent of the time and above 35 seventy-five percent of the time.