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Economic Outlook

U.S. Exceptionalism Continues Through 2025

Please refer to important disclosures on pages 28 and 29. Analyst certification is on page 28.

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Review – Looking Back

At this time last year, we thought the probability of the U.S. tipping into recession was uncomfortably high. Nearly all of the economy's historically best leading economic indicators were pointing to weakness—e.g., the yield curve, the PMIs, consumer and business sentiment. The labor market was already softening with a strong possibility of the Sahm rule soon being triggered (which ultimately happened in July), and consumers had almost fully depleted their pandemic savings. In addition, the global economy was facing one of its biggest election years ever, with more than half of the world's population heading to the polls in what was likely to be a referendum on the pandemic response and the inflation it created, and companies were increasingly reluctant to spend ahead of that election uncertainty. To top it off, there was an ongoing war in Ukraine and another one gaining momentum in the Middle East.

Meanwhile, the Fed was at the end of the fastest and most aggressive tightening cycle since the 1960s, and it has a poor record of engineering soft landings following these increases—only 3 of the last 12 tightening cycles have not ended in recession. With the last rate increase in July 2023—bringing the fed funds rate up from 0.75%-1% in June 2022 to 5.25%-5.5%—and given that monetary policy acts with a significant lag of one to three years, 2024 was likely to prove to be a difficult year. As a result, we dubbed it "the year of testing resiliency."

Happily, it is fair to say that the economy passed that test and a recession was skirted. The unemployment rate has remained low, inflation has continued to fall and has effectively reached the Fed's 2% PCE target with a 2.3% rate in October, the stock market has jumped another 28%, and the U.S. election has thankfully proved decisive and not ending in a morass of lawsuits, accusations of ballot rigging, and riots in the capital.

What Led to This Happy Outcome?

First and Foremost Was Continued Solid Spending by the U.S. Consumer
U.S. consumers had strong balance sheets and a structurally tight labor market, which resulted in faster real income growth and continued consumption. That expenditure mostly came from a resurgence in spending on services, although purchases of durables did not decelerate as much as might have been the case following the COVID surge.

Second, the Impact From Higher Interest Rates Continues to Lag
U.S. consumers are not highly leveraged and they locked in low mortgage rates, with a wave of refinancing during the COVID lows. As a result, the effective mortgage rate being paid by U.S. mortgage holders has only increased from a low of 3.3% to 4.0% today, compared with the prevailing 7.0% rate. Hence, while the rise in rates has put the skids under any housing recovery, most homeowners continue to prefer to sit tight and hang onto their low rates.

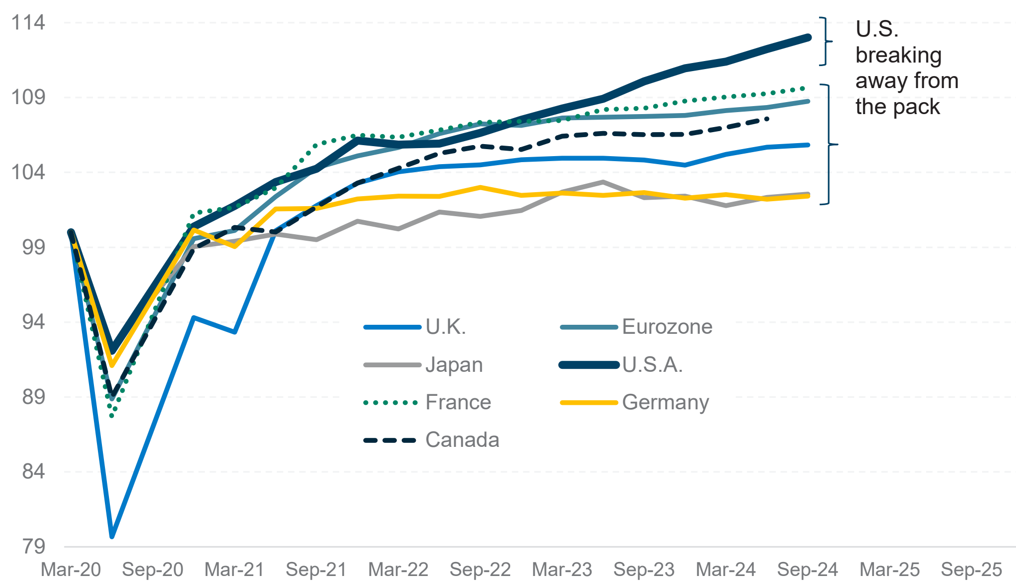
Third Is the Emergence of Generative AI
We are still very much in the early stages of a structural innovation wave, with generative AI bursting onto the scene this year with incredible force. While much of the progress so far has been via the *enablers* and less to the *adopters* of this technology, its growth has helped support the stock market and is arguably *already* starting to result in tangibly faster productivity growth, which has been a key factor in stronger GDP growth. The sharp increase in the stock market has also helped support consumption with a return of the wealth effect.

Last, but Certainly Not Least, Is Immigration

Over the last three years, the U.S. had a net addition of 10 million new immigrants. This is slightly more than the net amount that entered the country for the full decade up to 2019. This past year alone, there have been an estimated 3.3 million new entrants, the overwhelming majority of whom were spending money on groceries, apparel, services, and housing-related areas. This huge inflow has resulted in both faster GDP growth and lower inflation by putting downward pressure on wages and helping ease labor supply constraints.

Against this growth, most other G7 nations have struggled, affected by structural growth difficulties with little sign that these are yet being addressed. The upshot for the U.S. is that it became the standout growth leader among these G7 nations. Now the question for 2025 becomes, can this exceptionalism continue?

Exhibit 1
Real Economic Growth for G7 Nations
(Growth Rebased to 100 March 2020)



Sources: S&P IHS, William Blair Equity Research

Preview – What to Expect in 2025?

The economy managed to skirt a recession in 2024, and the greater probability is that it will be able to do the same in 2025.

Overall growth this coming year is likely to moderate from an above potential rate of 2.9% over the first three quarters of 2024 to 2.1%, and inflation is likely to remain sticky at above 2% levels (but also accompanied by uncomfortably high near-term acceleration risks). Nevertheless, there is still room for the Fed to continue to move back toward a now more elevated *terminal* rate.

The election of Donald Trump for a second term in office brings with it a strong dose of economic and policy uncertainty. His new nominated Treasury Secretary appointee Scott Bessent has been talking about a "grand global economic reordering." The scale of any such disruptions clearly raises the risks around growth and inflation (in both directions), and the potential for sudden shocks, whether domestically or internationally.

The president-elect's stated policy prescription would seem to follow two tracks, but with each leading to its own set of potentially different outcomes should there be no convergence between the two.

Track 1 takes the carrot approach and is designed to stimulate growth through policies such as tax cuts (renewing the expiring household tax cuts and potentially cutting the corporate tax rate to 15% from 21%) and deregulation. In addition, this track could generate a global peace dividend by resolving global conflicts.

Track 2, meanwhile, is more of a stick approach and is meant to incentivize growth through tax increases (i.e., tariffs on foreign imports), deportations (a potentially major supply shock to labor), and other efficiency measures resulting in lower government spending and less crowding out (potentially yielded through DOGE), and forcing greater domestic investment.

In an ideal world, the disinflationary impulses generated from policies such as deregulation, DOGE, and world peace will cleanly offset the inflationary impact from deportations, lower immigration, tariffs, and tax cuts. The end-result will of course depend on the introduction, timing, and execution of these policies—not to mention the response and/or retaliation from affected parties.

As we look ahead to the first half of 2025, we can anticipate a bump in economic activity fueled firstly by pent-up demand following the recent elections. Many businesses adopted a wait-and-see approach through 2023, holding back investments until the political landscape cleared.

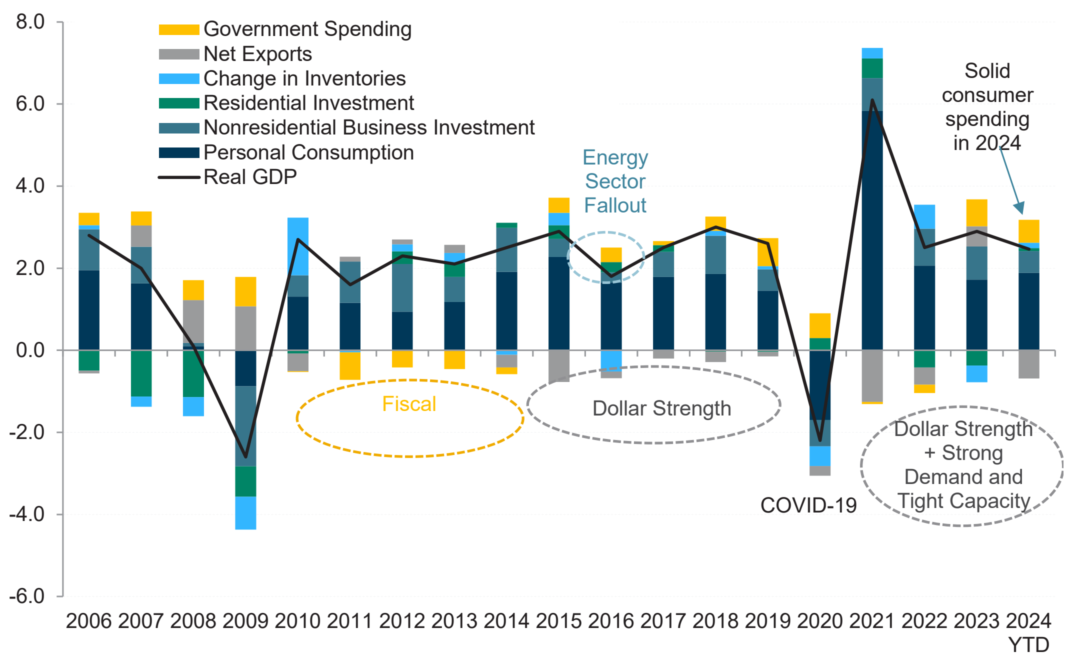
Second, companies are expected to engage in significant inventory restocking in an effort to get ahead of the proposed tariff increases.

Overall, while growth is likely to revert to more normalized levels following the pandemic's unprecedented disruptions, the outlook has also become increasingly uncertain following the election. Some of the proposed policies of the Trump administration could introduce considerable volatility, which can often expose underlying economic vulnerabilities. As stakeholders navigate this complex terrain, it will be crucial to remain vigilant and adaptable in response to these evolving economic dynamics.

Consumer Spending Hanging in There, but Vulnerabilities Are Apparent

Over the past year, the U.S. consumer has once again been a strong contributor to U.S. economic growth, rising by an average annualized rate of 2.6% over the first three quarters (exhibit 2). This was driven by continued spending on durable goods, notably autos, in addition to increased spending on healthcare. This spending should be anticipated to decelerate in 2025 as the consumer continues to normalize from the post-pandemic highs.

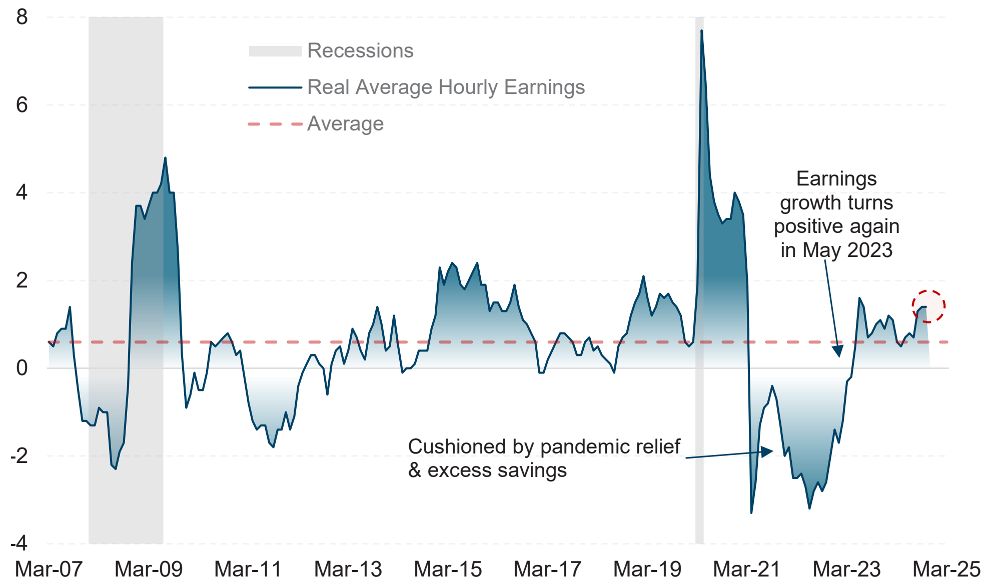
Exhibit 2
Contribution to Changes in Real GDP (Year-Over-Year SAAR)
in percentage points



Source: BEA, William Blair Equity Research

Encouragingly, this growth is being driven mainly by continued solid real income growth on the back of a structurally tight labor market and increased employee bargaining power, coupled with moderating inflation (exhibit 3).

Exhibit 3
Real Average Hourly Earnings Growth
(% Change on Year Ago)



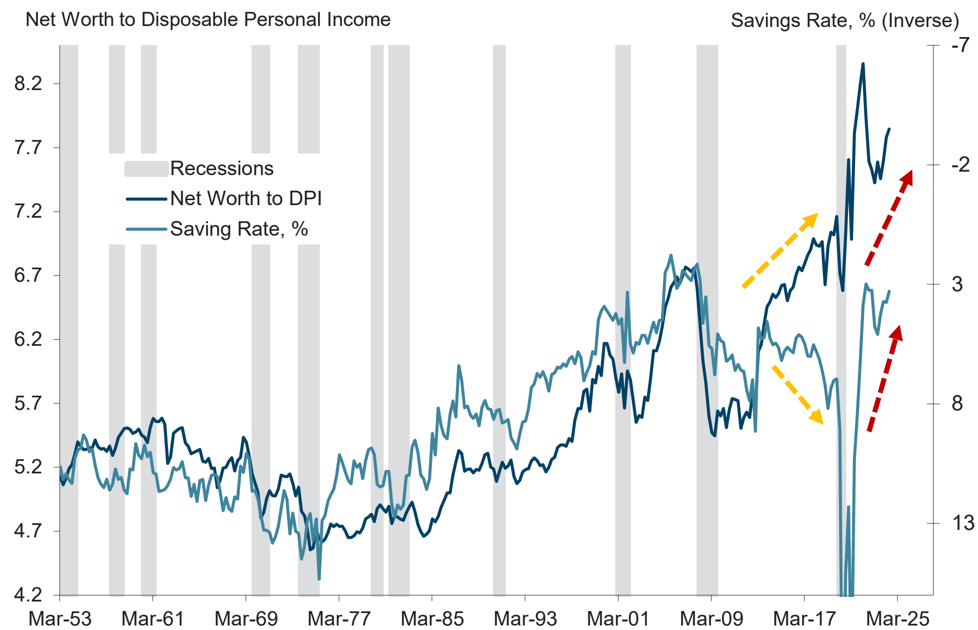
Sources: Bureau of Labor Statistics, William Blair Equity Research

Conversely, it is not being driven by a large surge in borrowing, as growth in consumer credit has remain subdued, making this pace of consumption that much more stable. Nevertheless, vulnerabilities exist.

The Wealth Effect

The first vulnerability relates to the fact that a large share of recent consumption has emanated from higher-income consumers, who are once again benefiting from a wealth effect following surges in equity prices, higher interest income, and rising real estate prices. These have boosted their net worth to $164 trillion, which was 7% higher in the second quarter than the previous year and 40% higher than the end of 2019 (exhibit 4). Consumers are once again starting to feel more comfortable in running down their savings on the belief that the stock market is "doing the savings for them." As a result, they are increasingly opening themselves up to potential shocks emanating from financial market volatility.

Exhibit 4
Household Net Worth and Savings to Disposable Personal Income



Source: Federal Reserve, William Blair Equity Research

The Immigrant Effect

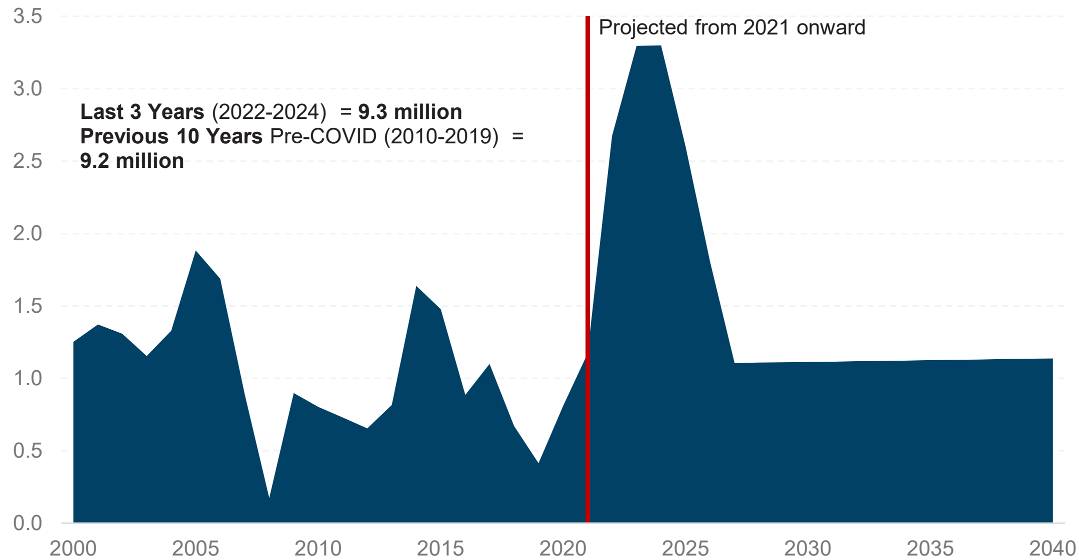
The second major area of vulnerability for consumer spending over the next few years relates to the potential for mass deportations under the new Trump administration. President Trump has promised at various times to deport 8 million, or even 20 million, illegal or undocumented workers. Current estimates are that there are 11 million such individuals in the U.S.

Aggregate net migration over the last few years has been staggering. In the last three years alone, there has been a net increase in total immigration of almost 10 million, which is slightly more than in the pre-COVID decade to 2019 (exhibit 5). For context, the size of the labor force at the end of 2019 was 165 million.

Whether these new immigrants are illegal or not, they are still consumers, purchasing food, clothing, and shelter. They have undoubtedly played a significant role in boosting PCE spending over this period. For example, the Congressional Budget Office (CBO) estimates that nominal GDP growth over the next decade will be 2.4%, or $8.9 trillion, above what would have been projected in the absence of this surge, i.e., if net migration had remained at a pre-COVID baseline average of about 200,000 per year. Consequently, any policies designed to repatriate these individuals would likely act as a significant headwind to consumption.

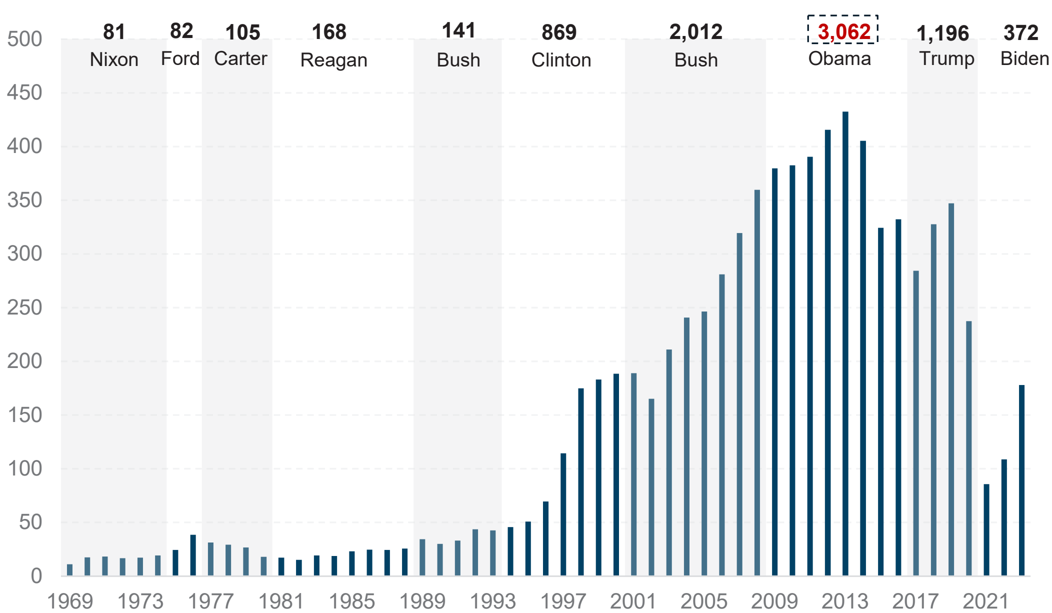
It often comes as a surprise to many to learn that the last period of significant deportations occurred under President Obama to deported over 3 million illegal immigrants. There are two significant differences, however. The first is this was spread over two full terms, and averaged 382,000 per year (exhibit 6). The second is that this was also in the aftermath of the global financial crisis, when there was a large supply of excess labor.

Exhibit 5
Net Immigration to the U.S.
(millions of people)



Source: Congressional Budget Office

Exhibit 6
Obama's Presidency Saw The Highest Number Of Deportations (Removals)*
(FY 1969 - FY 2023, '000s)



*Removals are the compulsory and confirmed movement of an inadmissible or deportable noncitizen out of the United States based on an order of removal . A noncitizen who is removed has administrative or criminal consequences placed on subsequent reentry owing to the fact of the removal
Sources: Office of Homeland Security Statistics Yearbook of Immigration, William Blair Equity Research

While the specifics of Trump's deportation policy remain uncertain, particularly regarding the scale and timeline for such changes, this policy would be especially problematic in light of today's structural tightness of the labor market, where numerous industries are already grappling with labor shortages. Those areas most at risk include the agriculture, construction, and various service industries such as restaurants, which heavily rely on low-skilled, lower-cost labor. The CBO estimates that it takes eight years for the wages of the new low-skilled immigrants to rise to the average for the people with the same level of education for the population as a whole.

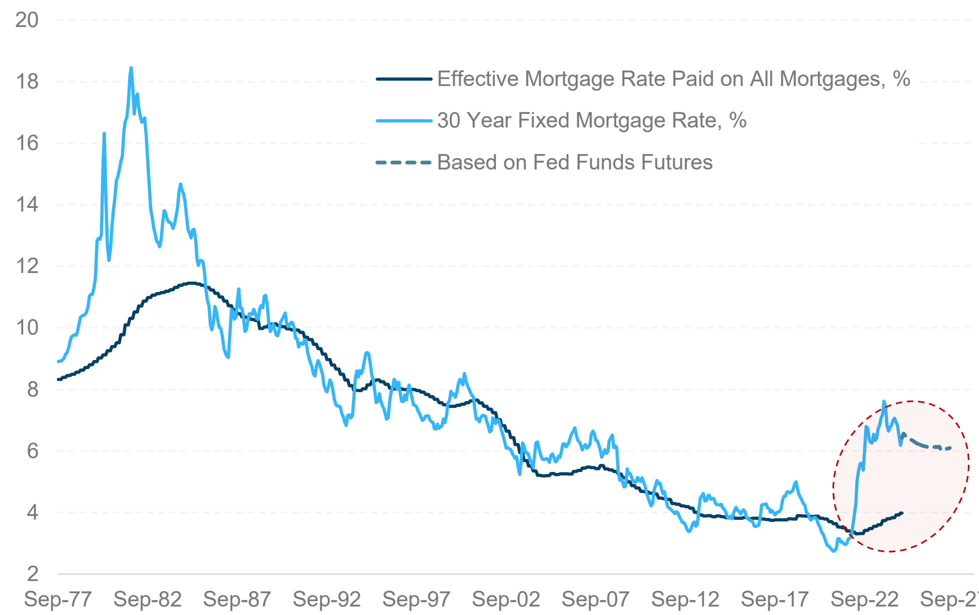
The Tariff Effect

The third area of vulnerability is any inflation and supply disruptions that are likely to result from the imposition of tariffs. As this past election proved, consumer sentiment around inflation remains raw and fragile, and another major step-up in prices could be very destabilizing. Many companies are already reporting that consumers are far more discerning in their spending patterns and are less prepared to splash out on highly discretionary items.

The Mortgage Rate Effect

Lastly, most mortgage holders locked in their lower rates during the depths of the pandemic, so the impact from the Fed's tightening cycle has been far more modest than might have otherwise been the case. However, even with the current expected pace of rate cuts (crudely boot-laced onto the current mortgage rate in exhibit 7), mortgage rates should continue to roll higher in the coming years. This will in turn further tighten the financial conditions being faced by consumers, bringing them to the highest rate seen in 2007 before the global financial crisis.

Exhibit 7
Effective Rate Currently Being Paid on All Outstanding Mortgages vs. Current Mortgage Rate (%)



Sources: Bloomberg, Freddie Mac, Census Bureau, William Blair Equity Research

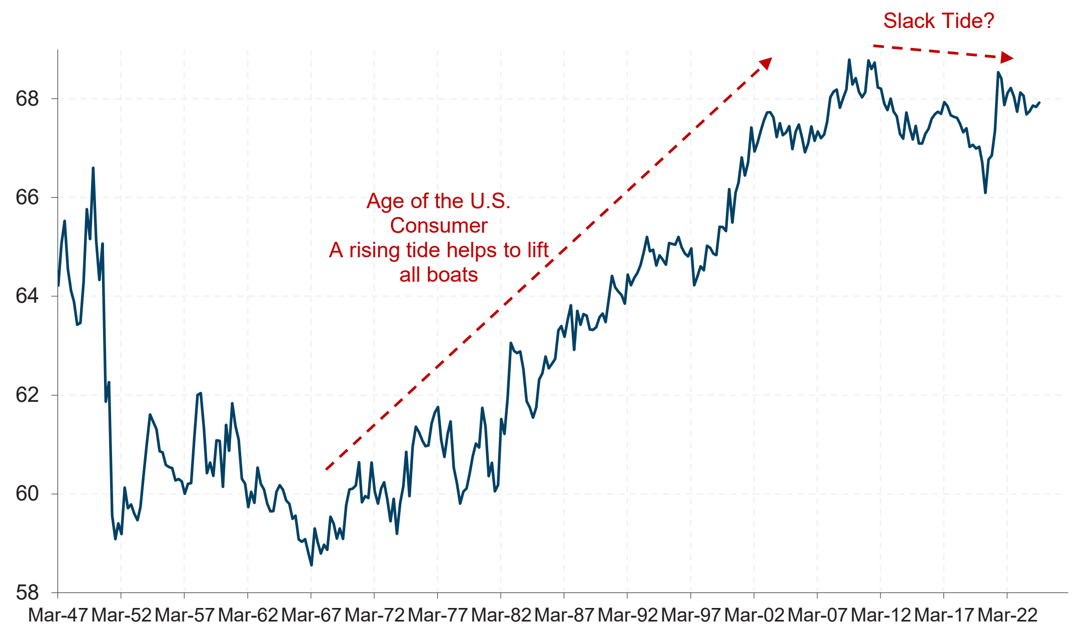
The upshot here is that consumers continue to hold up well; they have strong balance sheets, the unemployment rate is low at 4.1%, they are benefiting from positive real income growth and gains from financial assets, and the huge inflow of new consumers following the immigration surge has been a tremendous boon to aggregate spending. As a result, consumers are entering 2025 with momentum. Yet this pace of spending is likely to decelerate over the coming year as post-COVID demand trends continue to normalize, the lagged impact from higher interest rates continues to tighten consumers' financial conditions, and the impact from potential new policies being taken by the Trump administration starts to bite.

Business Investment – Where the Puck Is Going

The Age of the Consumer

From a late-1960s low of 58% of GDP, consumer spending has steadily advanced over the years at a pace of growth faster than the aggregate economy. The emergence of the baby boomers, women in the workforce, and the democratization of credit, along with increased immigration and globalization, helped make the decades from the 1960s right up to the GFC and a 2011 peak share of GDP of 69% as the age of the consumer. At almost 70% of GDP, the question was always how much more of GDP can the consumer really capture; the answer it seems is not much. PCE growth has returned to rates more consistent with trend GDP growth, and PCE's share of GDP has drifted lower to 67.9% (exhibit 8).

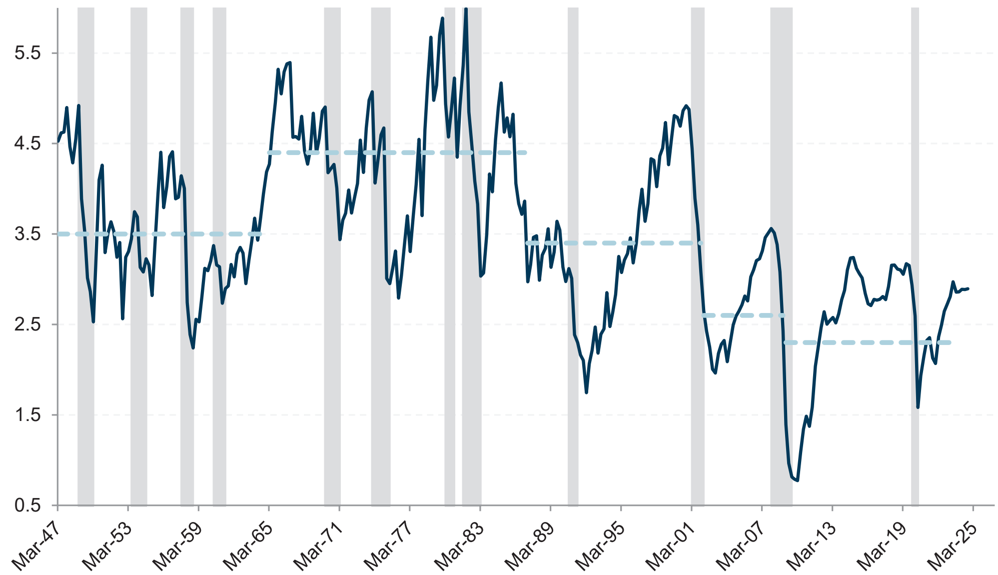
Exhibit 8
Nominal Personal Consumption Expenditures as % of GDP



Sources: Bureau of Economic Analysis, William Blair Equity Research

Today, many of those major structural trends that we saw driving consumers' steady ascent either have now dissipated or are relatively less powerful than other newer structural drivers of GDP growth. We continue to view the most powerful of new trends—and where we firmly believe the puck is heading—as the return of capex spending (exhibit 9).

Exhibit 9
Net Private Domestic Business Investment as a Percent of GDP, %



Sources: BEA, William Blair Equity Research

The Return of Capex Spending

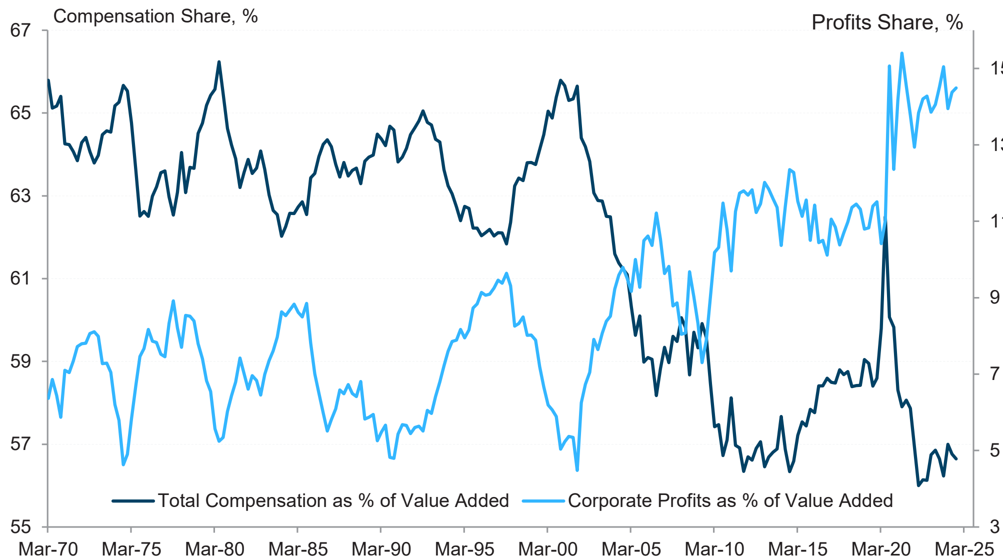
Capex spending is a structural trend that we have been tracking and writing about for several years. It is built on the back of two major challenges and two major opportunities for the corporate sector.

The first of these challenges relates to the fact that the capital stock is exceptionally old and needs refreshing. This was something many companies discovered during the pandemic, when supply chains broke down and they were forced to be more reliant on domestic productive capacity.

Second, the corporate sector is faced with a deepening structural labor supply shortage, as a result of both an aging population and slower growth or outright contraction in many other Western countries. The previous global supply glut of labor helped companies squeeze labor costs and structurally increase their margins. The plethora of cheap labor also took pressure off companies to undertake productivity-enhancing initiatives, with the result being the poor productivity gains seen over this period.

Going forward, however, the advent of fewer workers, coupled with the president-elect's plans to deport millions of workers and increase tariffs to encourage more domestic production, could put more upward pressure on compensation costs and, in the absence of greater pricing power and/or productivity gains, start to compress those margins (exhibit 10). As a result, there is a clear and strong incentive for companies to find capital investments to offset these costs through productivity initiatives.

Exhibit 10
Employee Compensation Share of Value Added vs Profits Share of Gross Value Added for All Nonfinancial Corporate Business



Sources: BEA, William Blair Equity Research

Capex spending opportunities exist with the incentives being brought about by President Biden's existing industrial policy incentives in the Inflation Reduction Act, CHIPS and Science Act, and Infrastructure Investment and Jobs Act. These are policies whose endgame—a stronger manufacturing base—is very much shared by President-elect Trump; his administration is therefore likely to be cautious about the extent to which these initiatives are disrupted. President-elect Trump is also providing further opportunities for capex spending through proposed policies around deregulation, lower corporate tax rates, and increased investment in the security and defense area.

Lastly, we are also in the midst of another major innovation wave, this time on the back of generative AI, presenting a huge opportunity for many companies to accelerate productivity gains and gain a competitive advantage. We are already starting to transition from the enablers of this new technology to the adopters.

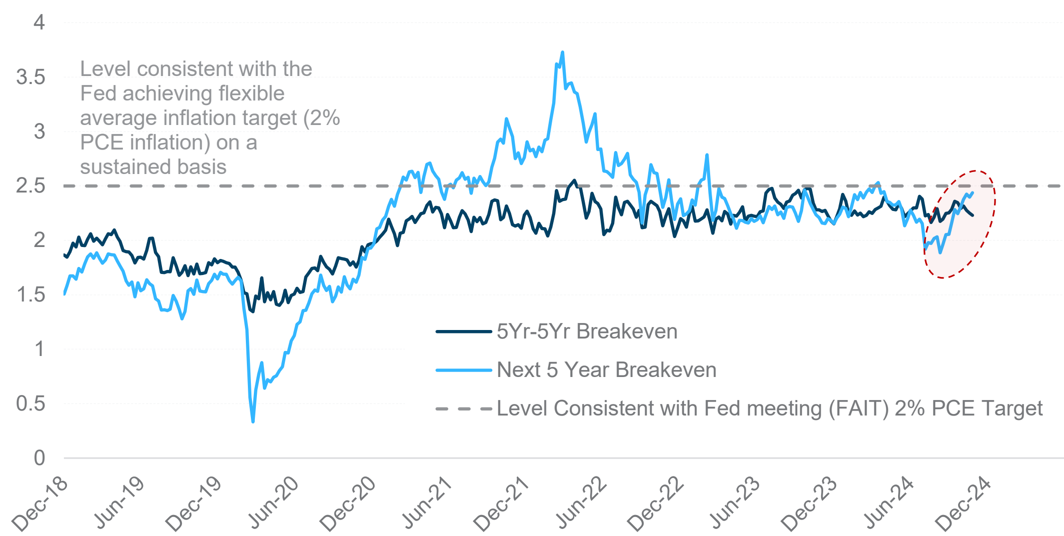
Inflation the Biggest Risk of 2025

In our mind, undoubtedly the biggest risk in 2025 is a resurgence of inflation. While this is not our base-case scenario, the potential for such a situation has increased. As it stands, the most likely scenario is that inflation remains sticky near 2.5%, as opposed to our previous view that it would comfortably return to about 2.0% in 2025 (core PCE is currently 2.8%, core CPI is 3.3%). This modest slowing will be achieved through further deceleration in growth; some easing in the labor market; the continued decline in rental prices pulling down the shelter component of the inflation basket; the Fed lowering rates to a still moderately restrictive level; and, importantly, continued dollar strength.

The main two risks around inflation emanate from:

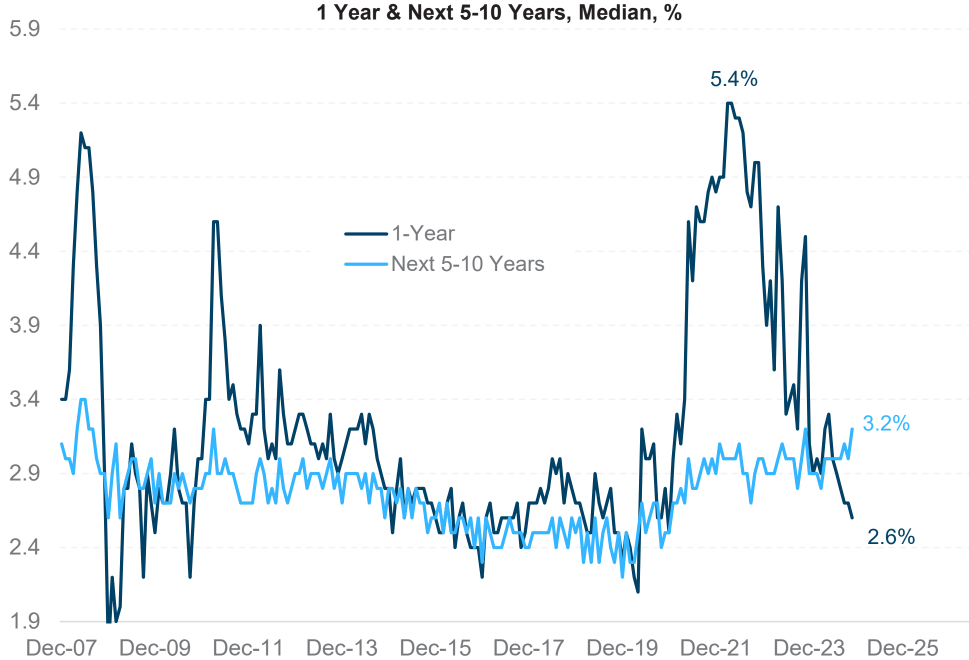
1. **Tariffs –** The inflationary impact from tariffs is likely to be transitory, in that they are a step up in price (a consumption tax), and these are not price increases being driven by "too much money chasing too few goods." Thus, these one-off price level changes start to enter the annual base comparison 12 months out. They are also relative price changes, not increases in the general price level; as a result, consumers will tend to offset more expensive purchases with reduced spending elsewhere. Yet, where the key inflation risk lies, is if these tax increases start to destabilize what are already fragile inflationary expectations coming off the back of the recent inflation surge (exhibits 11 and 12).

Exhibit 11
Inflation Expectations Over the Next 5 Years and the Subsequent 5 Years, %
(TIPS Breakeven 5-Year Yield and 5 Yr-5Yr Yield)



Sources: Bloomberg, William Blair Equity Research

Exhibit 12
University of Michigan Survey of Inflationary Expectations:
1 Year & Next 5-10 Years, Median, %

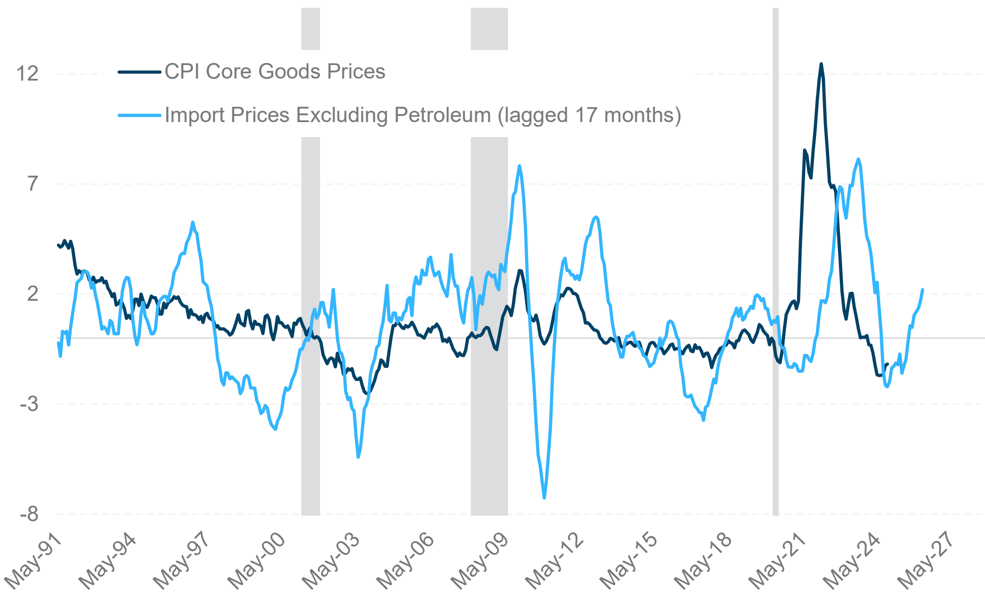


Sources: University of Michigan, Bloomberg, William Blair Equity Research

Unanchored longer-term inflationary expectations could cause inflation to rise and then make it sticky at those higher levels. Meanwhile, the fact that the new Trump administration has talked about phasing in tariffs on a rolling basis also suggests that this could result in higher rolling prices, further helping keep inflation higher for longer.

Import prices—which do not incorporate tariffs and excise taxes that are added later—are already heading upward and are signaling upward pressure on core consumer goods prices, taking them out of deflation (exhibit 13).

Exhibit 13
CPI Core Goods Prices vs. Import Prices* Less Petroleum
% Change on Year Ago



*Import prices do not include tariffs or excise duties paid by U.S. importers
Sources: Bureau of Labor Statistics, William Blair Equity Research

2. **Deportation –** The second major risk emanates from the plan to deport millions of undocumented or illegal workers. The Trump administration's plan to remove anywhere from 8 million to 20 million workers relative to a labor force of 165 million would not only have a very large impact on growth, but also act as a major supply shock to labor, at a time when the labor force is already structurally tight and many industries such as construction and agriculture are struggling to find workers. This will put renewed upward pressure on wages and depress margins unless companies can offset this with price increases and/or productivity enhancements.

There are also some downside risks. For example, a peace accord between Russia and Ukraine and easing tensions in the Middle East could open the supply chains once again to more direct purchases of sanction-less commodities, including oil and gas. This in conjunction with further strength in the dollar could result in a further softening in commodity prices.

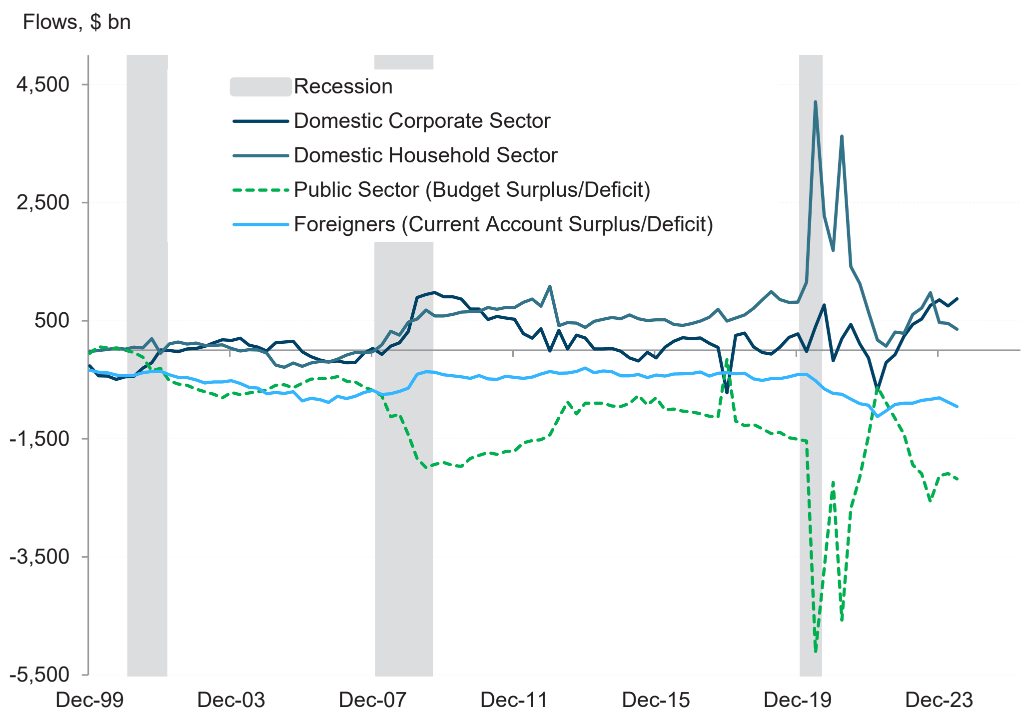
Many of those nominated for positions in the Trump administration also believe that the combination of widespread deregulation—particularly for the energy and real estate industries—and efficiencies that can be reaped from the DOGE will cleanly offset any inflationary impacts from other measures such as tariffs and deportations.

Dollar Strength Likely to Continue

As we wrote recently (here), we expect further dollar strength in the coming quarters. This is a world of relatively loose fiscal policy and still moderately restrictive monetary policy, which is generally dollar bullish.

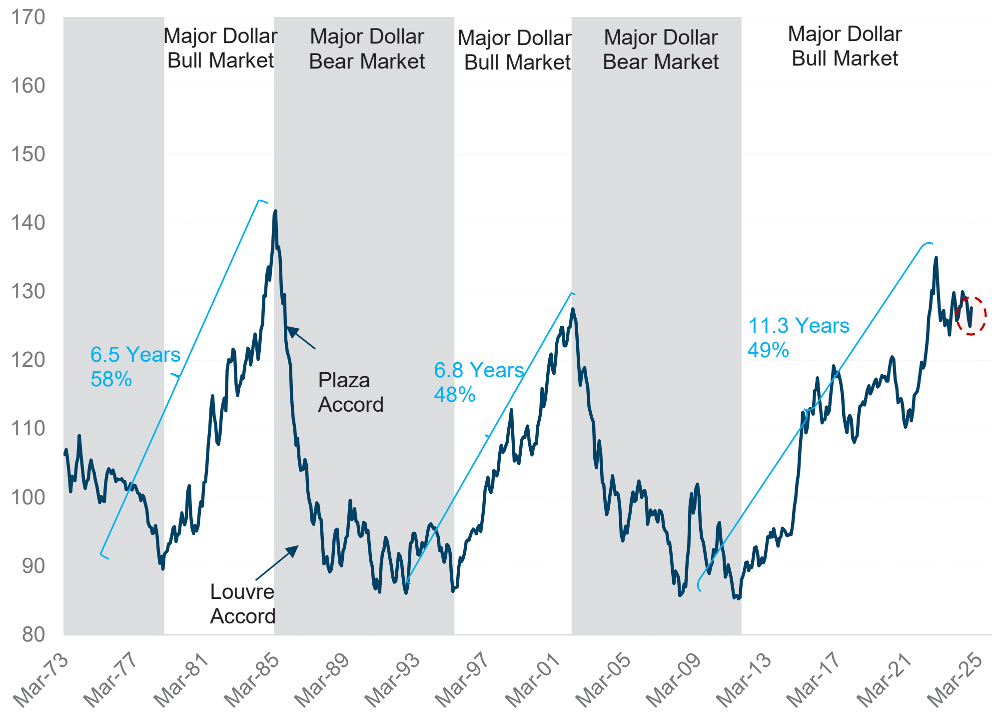
Tariffs, meanwhile, are also dollar bullish as they cause domestic consumers to purchase more domestic goods as opposed to foreign goods; and, in the absence of any major changes to the excess of demand relative to available savings from the consumer, corporate, and public sectors (e.g., little shrinkage of the budget deficit), it is difficult for the trade deficit to shrink (exhibit 14). This means that there will be further upward pressure on the dollar (exhibit 15).

Exhibit 14
Sectoral Balances
Private Sector Balance + Public Sector Balance + Foreign Balance = 0



Sources: Federal Reserve, William Blair Equity Research

Exhibit 15
Real U.S. Trade-Weighted Dollar (Advanced Economies)
Jan 2006 = 100



Sources: Federal Reserve, William Blair Equity Research; Shaded areas = dollar bear markets

To the extent that the dollar increases, it acts as a very important escape valve for any rising domestic inflationary pressures. Yet, this is not what President-elect Trump would like to see. Trump has talked about wanting a weaker dollar and forcing countries into some sort of new Plaza Accord (call it a Mar-a-Lago Accord) to raise the value of their currencies and lower the value of the dollar (but also not doing it in a way that would suggest they were moving away from the dollar as the world's reserve currency of choice!).

For foreign economies, there also are three key reasons to allow—or actively encourage—their own currencies to weaken.

1. Quite simply, they will want to offset as much as possible the impact from the tariffs by allowing their exchange rates to depreciate to absorb much of the shock from the increase in tariffs and protect their domestic exporters.

2. To the extent that tariffs and weaker U.S. demand put pressure on their own domestic economies, this will alter interest rate differentials and encourage further dollar appreciation looking for both yield and a safe haven from domestic weakness.

3. In anticipation of any Mar-a-Lago Accord, we would also not be surprised if many countries allow or actively encourage their currencies to decline. Thus, when it comes time to sign any accord, it would be that much easier to orchestrate a reflation of their currencies in compliance with any agreement.

A weaker currency, conversely, in the face of potentially heightened inflationary pressures resulting from the tariffs and other policy choices, would have significant risks attached to it all things being equal, as it would reduce the ability to export any domestic inflationary pressures and import disinflationary ones; it could also put greater pressure on the Fed to scale back further expected rate cuts, or possibly even force an increase.

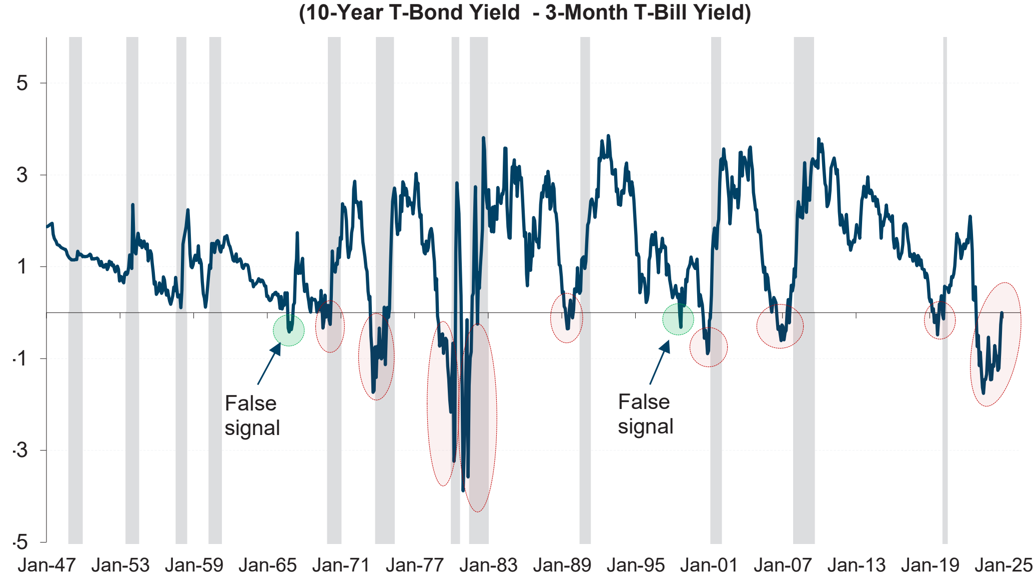
The Long and the Short of It – Yield Curve Dynamics

Over the course of 2024, we raised our expected terminal rate around the Fed's easing cycle. At the start of the year, a return to 2.5%, or possibly even 2% in the coming years, seemed quite feasible, bringing it below an estimated neutral rate of about 3.0%. Yet the unfolding soft landing, coupled with the election win and stated policies of the new Trump administration, would suggest that a new terminal rate of between 3.0% and 3.25% for this easing cycle by 2026 is more realistic, with the risks also tilted toward rates staying higher for longer. Financial market participants now believe a terminal rate of 3.5% will be reached in late 2026.

In reality, the impact from what has been the fastest Fed tightening cycle since at least the 1970s has not yet fully played out. These lags are the result of previously locked-in interest rates, yet as those contracts roll over in the next couple of years, unless rates are lowered significantly, policy will continue to tighten even in the face of current rate cut expectations. As a result, the current Fed rate cuts should be viewed less as being about providing monetary stimulus to spur on a failing economy and more as simply lessening the degree of monetary restrictiveness to not overtighten and miss out on the soft landing.

While we are likely to see shorter-term yields drift lower, the long end of the curve will likely have to do more of the heavy lifting with regard to fighting inflation and attracting buyers of government debt. As a result, longer-term interest rates should be viewed as already being close to the point of fair value, with now more limited space for yields to fall further. The end-result will be a continued re-steepening of the yield curve (exhibit 16).

Exhibit 16
Treasury Yield Curve
(10-Year T-Bond Yield - 3-Month T-Bill Yield)



Sources: Bloomberg, William Blair Equity Research

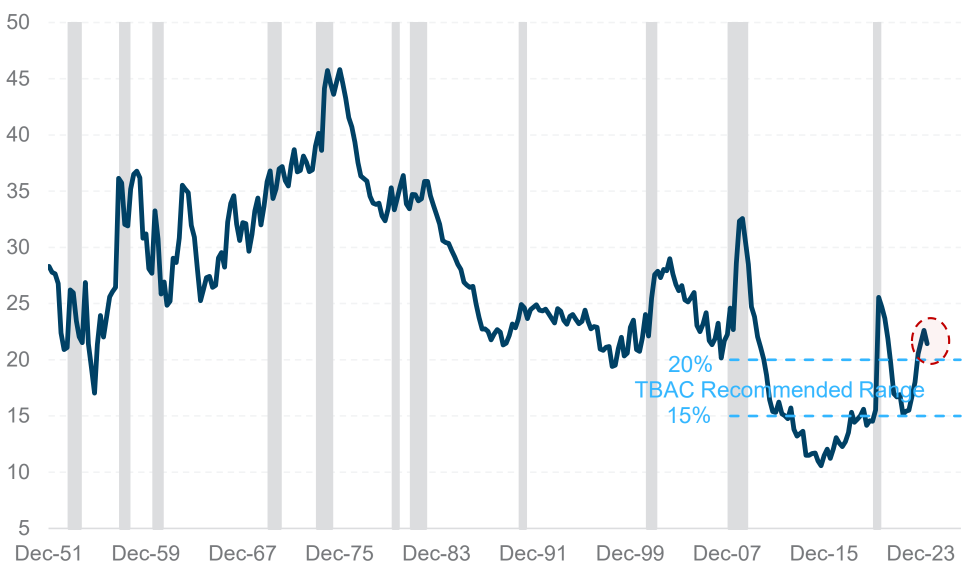
Two Risks Facing the Longer-Term Yields in 2025

There are at least two major risks facing the longer-term yields in 2025. The first is the aforementioned return of potential for an increase in inflation.

The second relates to increased debt issuance. While there is no strong correlation between the size of the federal debt and Treasury yields, we believe that supply still matters and that supply is steadily increasing. Even before the election of Trump, net debt issuance was estimated to be $2 trillion per year over the next decade. According to the Committee for a Responsible Budget (CFRB), the Trump policies will add a further $7.75 trillion to the projected debt burden through fiscal 2035, on the back of further tax cuts and other spending measures, and against insufficient revenue raises via tariffs and government efficiencies.

It is also apparent that over the last two years there has been a large surge in T-bill issuance, which has brought its share of total Treasury debt outstanding to over 20% (exhibit 17). While there is no official rule as to what exact share needs to be maintained, the Treasury Borrowing Advisory Committee (TBAC) has stressed a range of 15%-20%, a level that the Treasury has consistently breached since the third quarter of 2023.

Exhibit 17
Treasury Bills Share of Total Treasury Debt Outstanding, %



Sources: U.S. Treasury, William Blair Equity Research

While Treasury Secretary Janet Yellen has strenuously denied that this was the intention, the effect of issuing more shorter-term debt over longer-term debt has helped twist the yield curve—putting more pressure on shorter-term yields (where demand has been high) and easing pressure on longer-term yields at a time when inflation has been a concern and there has been increased momentum for these yields to rise. Over the coming year, we should expect this strategy to start to be unwound, with more issuance at the longer end of the curve placing upward pressure on those yields.

That supply pressure is also being felt with the primary dealers who are charged with smoothing its flow to market. They are increasingly finding themselves stuffed with growing amounts of inventory on their books (exhibit 18), leaving less capacity to act as the market's shock absorber in other areas of financial markets. It is quite possible that the continuation of these capacity constraints over the coming year starts to show up in greater market volatility and could be at least one reason behind what is likely to be a further tapering and eventual end of the Fed's QT program later this coming year.

Exhibit 18
Primary Dealers Net Position in U.S. Treasury Securities
($M)

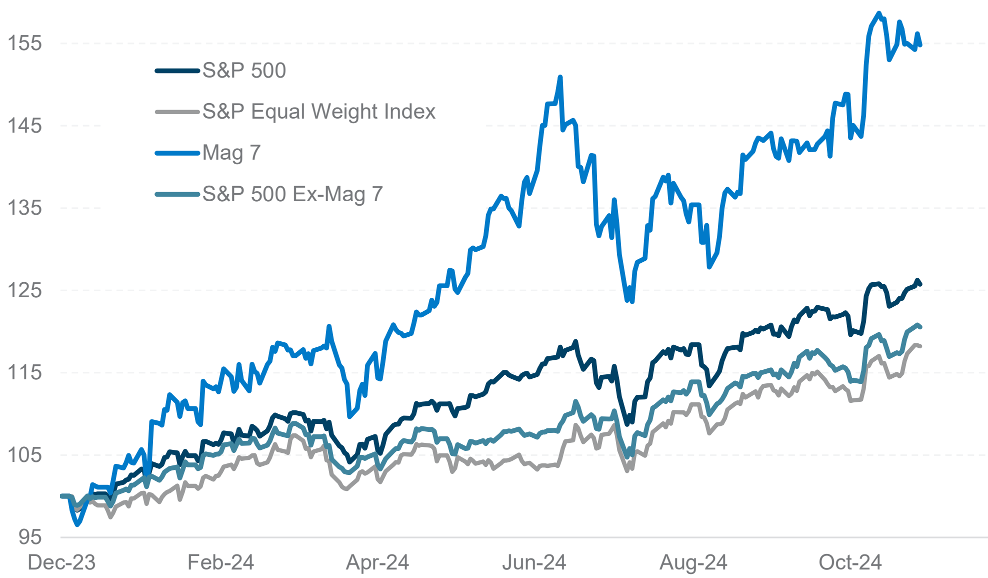
Sources: Bloomberg, Federal Reserve Bank of New York, William Blair Equity Research

The upshot here is that while there is not an obvious correlation between rising debt and changes in Treasury yields, in the coming year, we will likely see a twisting back in issuance toward longer-term debt. This will come at a time when net issuance is running near $2 trillion per year, the corporate sector is heading toward existing debt maturity walls, and primary dealer capacity is already looking quite stretched. As a result, while there is likely to be space for shorter-term yields to come down on the back of further Fed easing, further progress at the long end of the yield curve looks more difficult.

Still Early Days in the Smidcap Rotation

The current 12-month trailing P/E ratio for the S&P 500 at 25 times and the forward P/E ratio of 22 times leave the large-cap market richly priced with little room for error. As most are by now fully aware, a large part of this valuation multiple results from the astounding performance of the Magnificent Seven. The seven stocks have increased by 61% so far this year, versus the aggregate S&P 500 performance of 27% and the equally weighted market performance of 18% (exhibit 19).

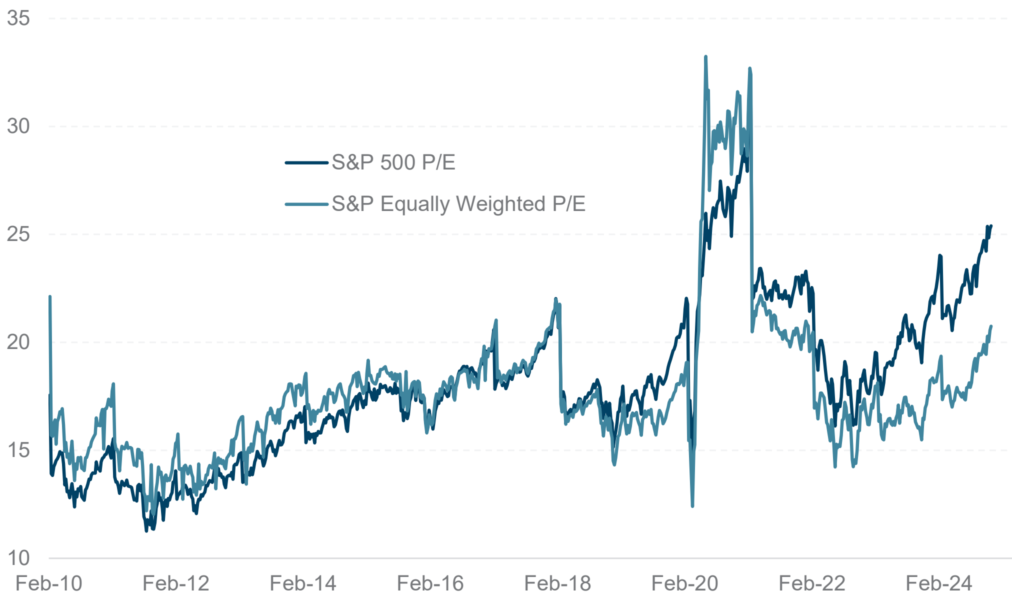
Exhibit 19
S&P 500 vs. Magnificent Seven
(Indices Rebased to 100, December 28, 2023)



Sources: Bloomberg, William Blair Equity Research

If we exclude the influence of these stocks and focus on the remainder of the index, as measured by the equally weighted index, it is also fully valued at 21 times earnings. And while this figure is at the upper end of its range, it is noticeably lower than the aggregate index that includes the Magnificent Seven, which now account for 30% of the entire index (exhibit 20).

Exhibit 20
S&P 500 and S&P 500 Equally Weighted Index
12-Month Trailing P/E Ratios

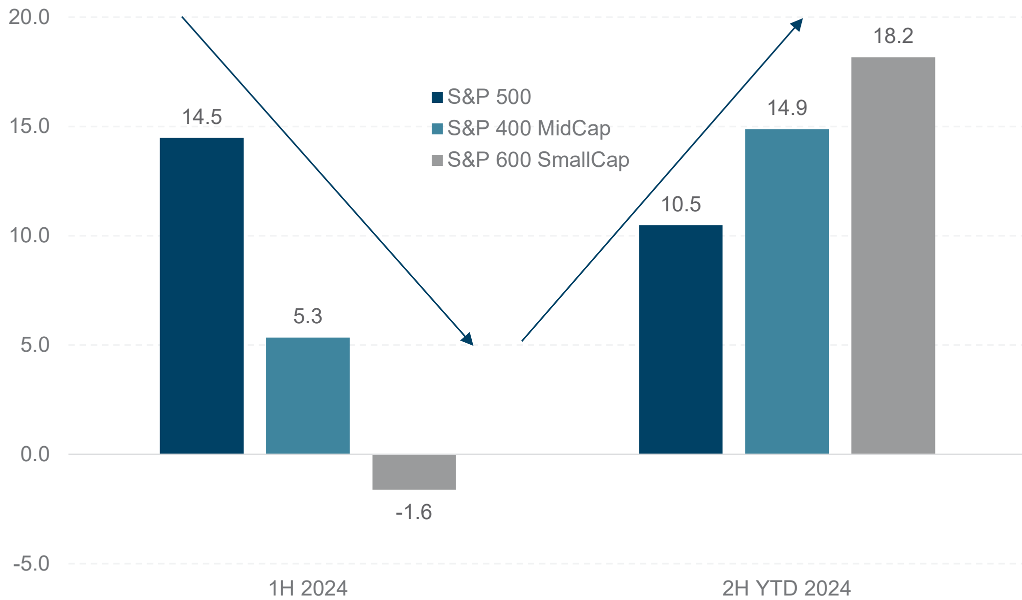


Sources: Bloomberg, William Blair Equity Research

As investors who still believe that valuation matters, where we remain most excited is once again about smidcap stocks.

We were similarly excited about smidcaps at the end of last year, only to see several head fakes and these stocks subsequently underperform year-to-date. In reality, this more difficult period came through the first half of the year, and since the end of the second quarter, the mid- and smaller-cap stocks have been gathering momentum and handsomely outperformed the large caps through the second half of the year. We believe this trend is still in its very early innings and is expected to continue into 2025 and beyond (exhibit 21).

Exhibit 21
S&P 500, S&P MidCap, and S&P 600 SmallCap Indices Performance in First and Second Half of 2024, %

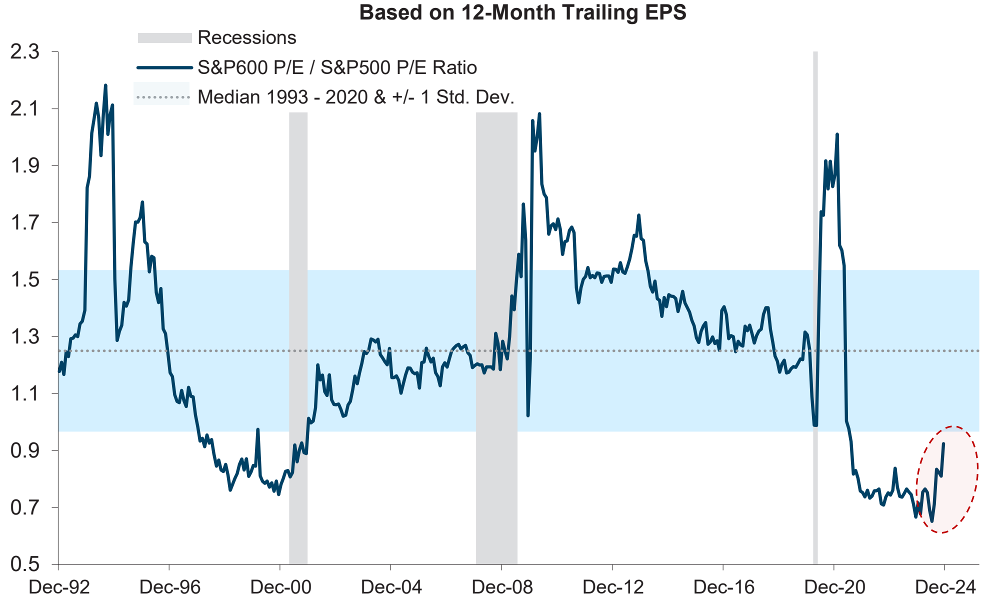


Sources: Bloomberg, William Blair Equity Research

There are a few key reasons to believe this.

First and the most striking, smaller-cap valuations remain exceptionally attractive on a relative basis across just about all valuation metrics. Many investors now feel dispirited with these smaller names, and there is widespread sentiment that this is a broken market. As exhibit 22, for example, shows, we have not seen this level of apathy to the smaller-cap stock since the late 1990s, and the current reading suggests a lot of bad news is still being fully discounted. Furthermore, while we have already seen some relative multiple expansion, the ratio remains highly attractive and still just outside its normal historical valuation range. Encouragingly, current earnings estimates are also favorable for this cohort with an expected increase of 12.8% for the S&P 500, 13.6% for the S&P 400 MidCap, 17.6% for the S&P 600 SmallCap index, and 41.2% for the Russell 2000.

Exhibit 22
Relative P/E Ratio: S&P 600 / S&P 500
Based on 12-Month Trailing EPS



Sources: Bloomberg, Capital IQ, Factset, William Blair Equity Research

Second, the election of Trump and his greater focus on America First policies, which aim to support domestic growth at the expense of foreign competitors, should help provide some much-needed shelter for these smaller and midsize domestic companies, encouraging both greater production and consumption domestically. While tariffs will help make domestic alternatives more attractive, any form of deregulation will also come as a significant tailwind for smaller-cap companies, where elevated regulation has proved a significant barrier to entry protecting the established larger-caps.

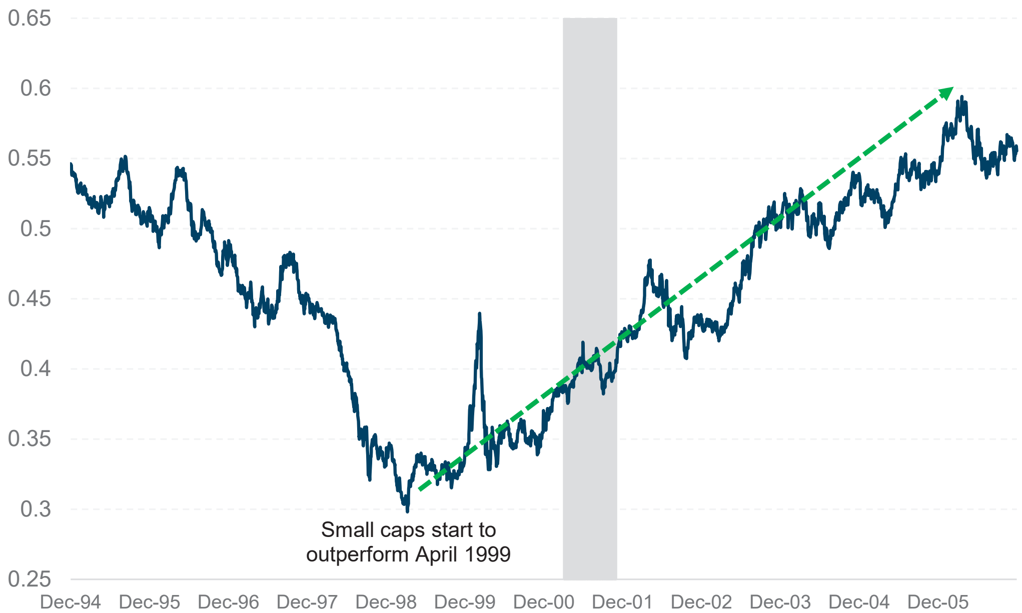
Third, if we are correct and we continue to see a stronger dollar, this too is likely to weigh more heavily in favor of the more domestically orientated mid- and smaller-cap stocks that have less international exposure, which helps when it comes to both demand and the translation of foreign earnings.

Fourth, there is good reason to believe that the election of Trump will also open the market to a new M&A cycle among lower market-capitalized companies. While there seems to be continued strong antitrust sentiment from this administration, this relates more to the largest-cap companies and less to the mid- and smaller caps. Shorter-term interest rates are also likely to fall further, companies have plenty of cash on their balance sheets, and there has been a lot of talk about pent-up demand waiting for a friendlier regulatory environment and more clarity into economic growth.

Fifth, we see some similarities with today's environment to that of the late 1990s. While smaller-stock cycles most often start in the depths of an economic recession, the one key exception to that regularity was the 1998-2006 cycle. This was also the last time that smaller-cap stocks were as undervalued as they are today and when the market was also in thrall to a smaller group of tech stocks. In fact, when the 2001 recession did finally happen smaller-cap stocks completely ignored it and continued to outperform the large caps.

What was notable back then (and is depicted in exhibit 23) is that small stocks started to outperform large almost three years before the peak and crash of the dot-com bubble. That is to say that for this part of the market to start to outperform, we did not need the tech bubble burst, nor was there necessarily a major shift in market sentiment away from the large-cap tech stocks.

Exhibit 23
Relative Performance of Russell 2000 vs. S&P 500
1994-2006



Sources: Bloomberg, William Blair Equity Research

Rather, because of the strong performance of the large-cap tech stocks, many portfolio managers were being forced for risk-control purposes to reduce outsized portfolio weightings back down to more acceptable levels and also diversify their holdings with the excess funds, which came in the form of a shift of that surplus from large-cap growth to smaller-cap value stocks. Today, because these stocks are so underowned, as investors start to diversify their holdings away from the Magnificent Seven, it would not take much in the way of new money inflows to see performance accelerate quite rapidly in what is likely to be the early innings of this new smidcap cycle.

Conclusion

The past year has happily managed to be far more resilient to many of the prevailing economic headwinds than we had feared it might be. The shifting consumption patterns following COVID, the structurally tight labor market, and strong private sector balance sheets with debt that has been locked in at low rates for the duration, in addition to another surge of over 3 million net immigrants, have helped boost consumption and moderate inflationary pressures.

Growth will likely decelerate closer to its trend rate. This may be driven by further expansion in consumer spending and, importantly, the ongoing wave of greater business investment in new capital.

There is unfortunately a tremendous amount of uncertainty about the extent to which the proposed policies of President-elect Trump will be implemented. There are also many inherent inconsistencies in those policies (e.g., the desire for tariffs, tax cuts, stronger domestic growth, in addition to a weaker dollar), and policies that are meant to be disinflationary might not perfectly offset those that are more inflationary to the extent that this new administration hopes. As a result, while there are some downside risks to inflation (falling commodity prices and deregulation), the greater risks look to be tilted to the upside (deportations and tariffs).

The Fed is happy with the current economy and thus wants to return to a neutral setting before the lagged effects from those current policy rates further restrict growth. However, following the election of Donald Trump, it will want to be a little more cautious than would have been the case under a Harris administration in the speed with which it achieves that goal.

The dollar is likely to remain strong in light of this ongoing U.S. exceptionalism, which President-elect Trump is attempting to double-down on.

Such an environment is also likely to be consistent with the continued outperformance of the smidcap stocks, which are benefiting from highly attractive valuations, a friendlier regulatory environment, lower interest rates, tariff protection, and investment flows that are increasingly tilting toward diversification into underowned sections of the market.

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NASDAQ: 19859.80

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Market Perform (Hold)	28	Market Perform (Hold)	0
Underperform (Sell)	1	Underperform (Sell)	0

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