HIGHTOWER
Investment Solutions

Hightower Investment Solutions: 2024 Market Recap and 2025 Outlook

Building on Momentum

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2024: The Realized Soft Landing

2024 was highlighted by lower inflation, strong earnings growth, a robust consumer, and declining interest rates. Market participation broadened relative to 2023; the technology sector contributed 43% to the S&P 500's total return in 2024, compared to 55% in 2023. When looking at the Magnificent 7, this cohort made up 53% of the S&P 500's total return in 2024, compared to 62% in 2023.

The Treasury yield curve steepened as the Fed began cutting interest rates with higher growth expectations in a second Trump presidency. This steepening will likely continue as the Fed remains focused on price stability and maximum employment.

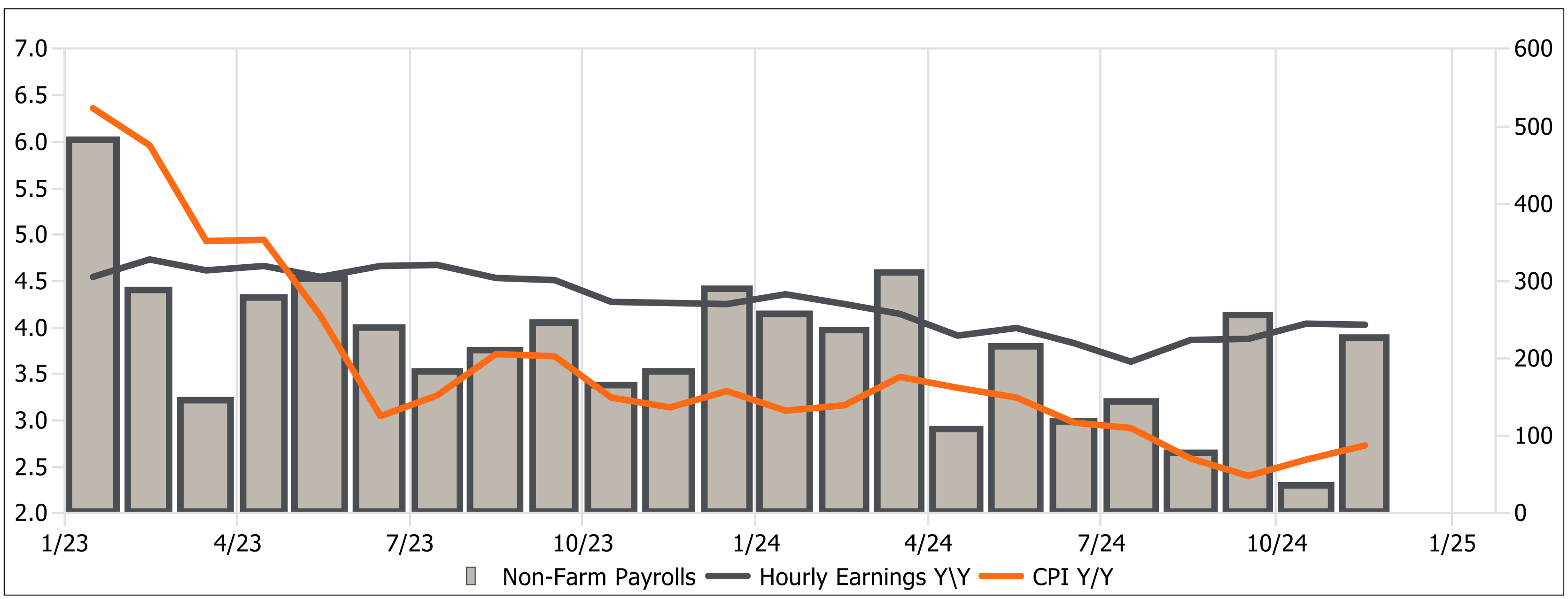
2025 is likely to bring lower inflation and interest rate pressure, both supportive of economic expansion. A balanced labor market and healthy consumers will also support further growth in the economy.

The Recession that Never Materializes

Entering 2024, expectations for the market and economy were low. In their 2024 outlook, J.P. Morgan projected a 25% chance for a U.S. recession by the first half of 2024, and 45% chance by the second half of 2024. Goldman Sachs stated that the risk of a recession in 2024 was 30%. Both institutions had little faith in the U.S. stock market; J.P. Morgan believed the S&P 500 would end the year at 4,200, with Goldman Sachs projecting 4,700. No recession materialized, and the S&P 500 closed the year just shy of 6,000.

Economic and market resilience was the name of the game in 2024. Inflation trended towards the Fed's 2% goal, the labor market remained balanced, and companies grew earnings above estimates. The unemployment rate is at its long-term average and wage growth is above inflation, supporting consumer activity. Market performance and economic activity beat almost all expectations that were held entering 2024.

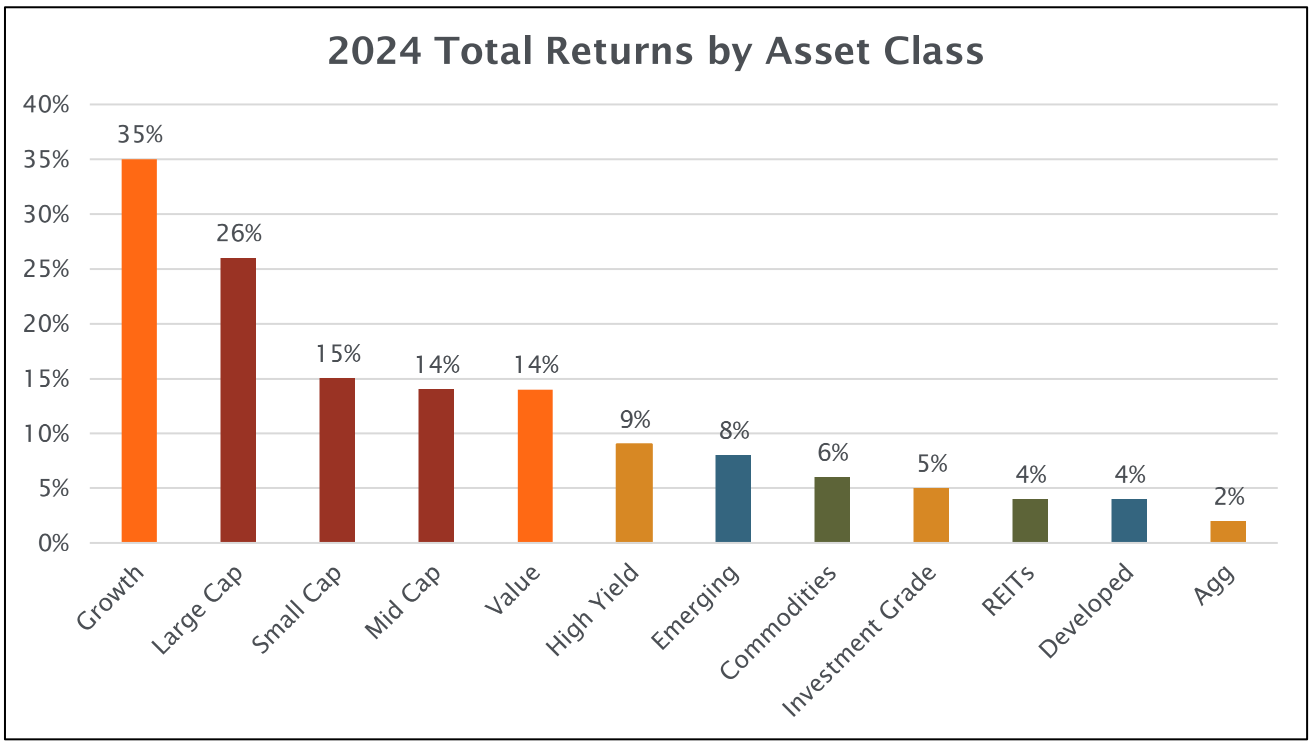
2024 Brought Lower Inflation, a Strong Labor Market, and Healthy Wage Growth



Source: FactSet (chart). As of December 31, 2024.
Source: J.P. Morgan. As of December 13, 2023.
Source: Goldman Sachs. As of November 21, 2023.

2024 Asset Class Performance

- 2024 marked another strong year for markets; the S&P 500 rose 24% following 2023's gain of 25%. The past two years marked the first instance since 1997-1998 of consecutive years with returns exceeding 20%.
- Growth outperformed value by 20 percentage points. Since the start of 2023, growth is up 89% while value is up 22%.
- The top-performing sectors included communication services, financials, and consumer discretionary. All three of these sectors gained over 25% in the year. Every sector was in the green, with materials being the laggard, down -1.46%.
- U.S. large cap growth remains one of the best-performing areas of the market. The equal-weight S&P 500 gained 11% in 2024, lagging the market-cap weighted S&P 500 by 13 percentage points. But in the second half of 2024, the equal-weight index performed in line with the market-cap weighted index pointing to a broadening, both gaining ~7.5%.
- Fixed income securities provided a positive total return, with high-yield bonds gaining nearly 10%.
- If you managed to stay invested, shutting off the emotions of an election year, you likely generated solid returns in 2024.



- The **S&P 500** ended 2024 higher once again, gaining 24%.
- **Gold** and **silver** had strong years, gaining 27% and 22%, respectively.
- The **10-year Treasury yield** opened 2024 at 3.88% and ended the year at 4.57%. The yield got as high as 4.74% in April, and as low as 3.58% in September.
- **U.S. Crude** closed 2024 at $71 per barrel, near the bottom end of its trading range over the last two years. U.S. crude oil price returns were relatively flat in 2024.

Source: FactSet (chart). As of December 31, 2024.

Fed Expectations: Where is the Neutral Rate?

2024

Heading into 2024, the market anticipated rate cuts, but the timing and size were unknown. Markets estimated six 25 bp cuts, totaling 150 bps worth of cuts. This estimate ended the year being a tad aggressive, as the Fed cut a total of 100 bps across the final three meetings of the year.

The December FOMC meeting was more hawkish than expected; one member voted against a 25 bp cut, and many non-voting members also voiced concerns against a cut. Going forward, many are questioning how low the neutral rate truly is: the interest rate at which monetary policy is considered neither stimulative nor restrictive to economic growth. The Fed believes this rate is 3.0%, but the market says it's higher.

2025

In 2025, expectations are for two 25 bp rate cuts. This would bring the Fed Funds Rate to 3.75-4.00%, which is still above the Fed's terminal rate of 3.0%.

Our belief is that the Fed's terminal rate will likely tick higher this year. We prefer higher interest rates and higher growth to lower interest rates and lower growth, as the former results in greater earnings growth, and thus economic growth.

The economy is growing above trend, with 4% wage growth, inflation near the Fed's goal, and an average unemployment rate relative to history. Further rate cuts into an expanding economy could reignite inflation and put the Fed in a predicament.

The Fed is likely to cut in 2025, but possibly not to the extent believed as of today. The Fed lowered its policy rate less than expected in 2024, so less than two cuts in 2025 would not be out of the ordinary.

Inflation or the Labor Market: Where is the Fed's Attention?

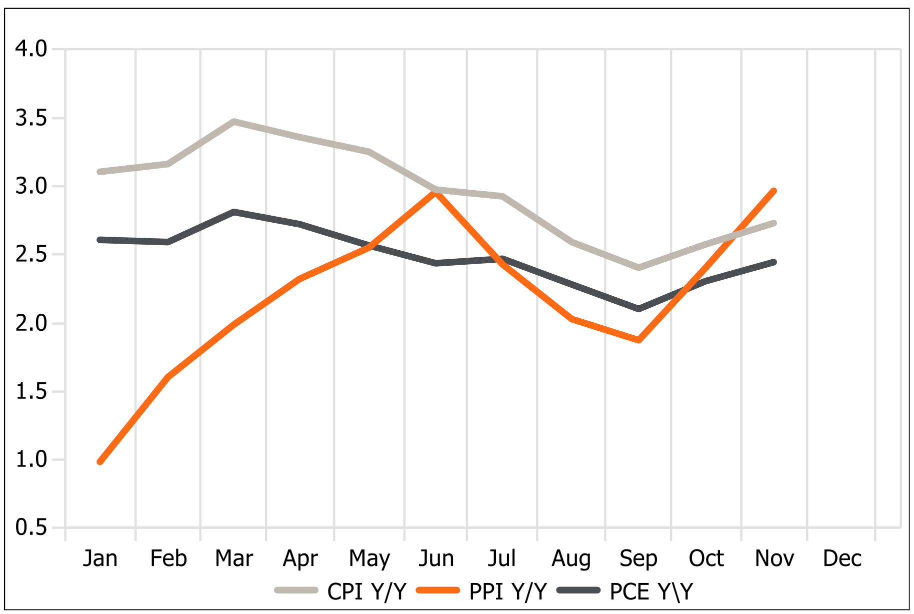
During 2024, the Consumer Price Index (CPI) averaged 2.96% y/y, and the Producer Price Index (PPI) averaged 2.19% y/y. The Fed's preferred inflation gauge, the Personal Consumption Expenditure Index (PCE), averaged 2.51% y/y. All three inflation readings are close to where they began 2024 at, but they still fall short of the Fed's 2% long-term target.

In December, Fed Chair Jerome Powell noted that the U.S. economy is in "a really good place". But Powell also stated that he would like to see further progress on inflation as they think about further cuts. The Fed cut in three consecutive meetings to end 2024, with the Fed Funds Rate now at 4.25-4.50%, down from 5.25-5.50% at the start of 2024.

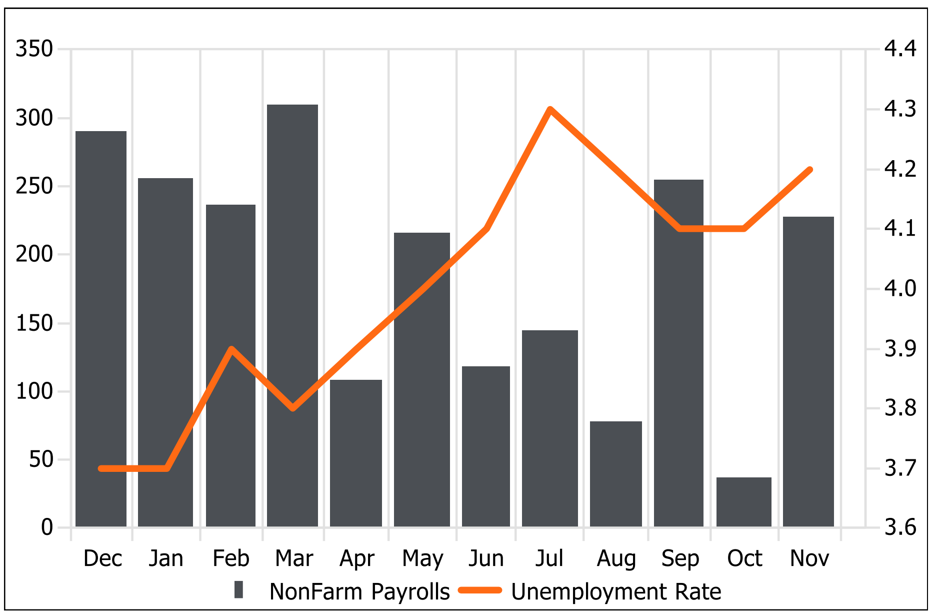
The labor market has cooled but remains balanced. Monthly job gains averaged 190K in 2024, with an average unemployment rate of 4% - both better than the 10-year averages (160K and 4.70%, respectively).

Our view is that we are in a soft landing. The Fed will continue to be cautious with rate cuts, remain attentive to data, and react quickly to any unexpected weakening in the economy. The U.S. economy should remain robust in 2025.

U.S. Inflation Data Has Leveled Off Since Summer 2024



Job Gains Remain Steady With a Rising, But Tamed, Unemployment Rate



Source: FactSet (charts). As of December 31, 2024.
Source: Federal Reserve. As of December 18, 2024.

A Normalizing Yield Curve

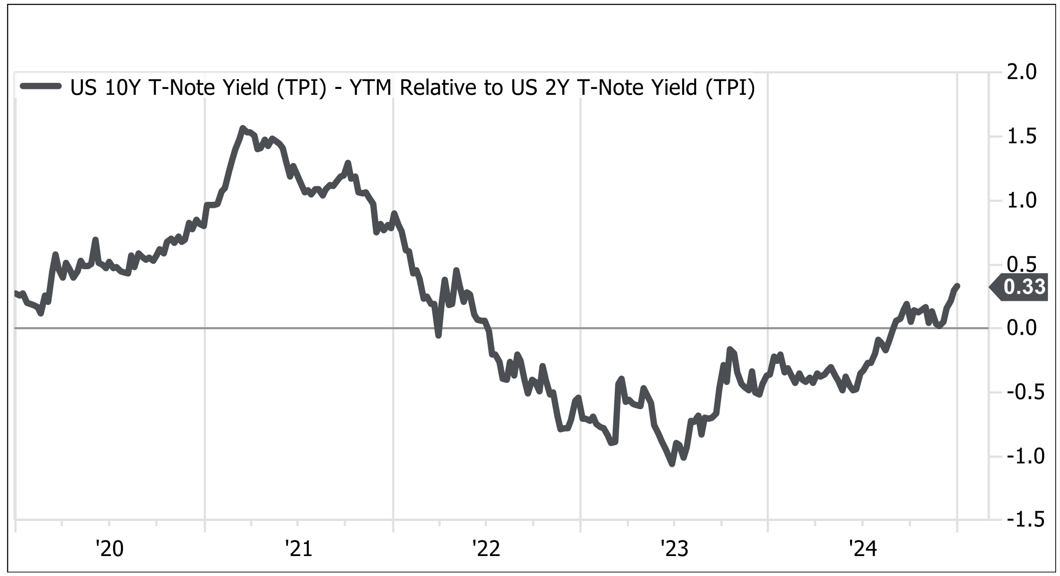
Interest rate uncertainty spiked in 2022. Short-term yields rose at the beginning of the year, moving ahead of the Fed. They began declining in late 2023, once again front-running the Fed. For the past two years, bond yields have done much of the work for the Fed.

But now, the bond market seems to be disjointed from the Fed. Bond yields moved lower in late 2023, anticipating cuts that never came. Once cuts came in late 2024, bond yields rose – indicating that the Fed might be incorrect to ease into an expanding economy.

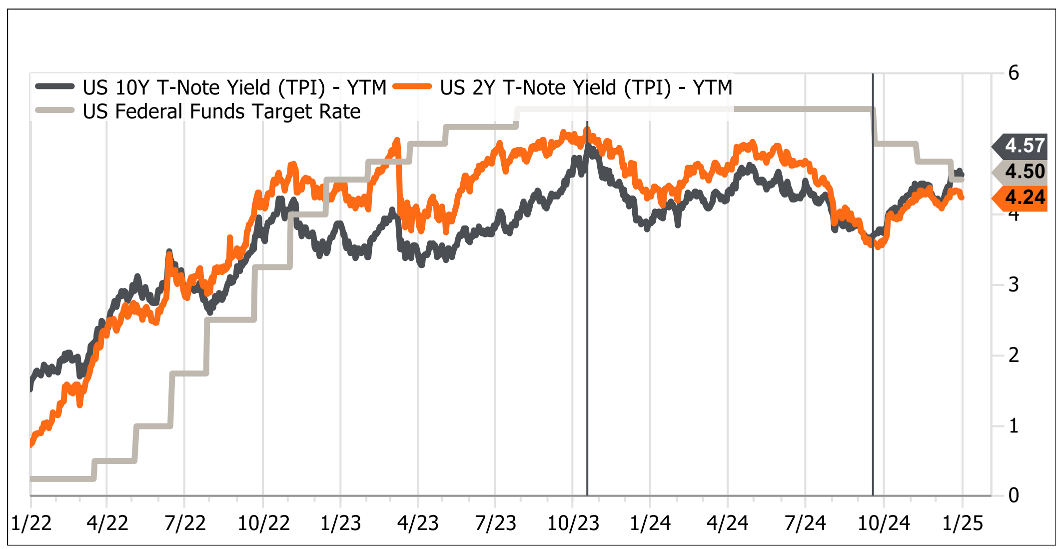
The yield curve turned negative in mid-2022 as the Fed raised front-end rates with the long-term economic environment unknown. This changed in 2024 as rate cuts began and the economic environment became clearer. An upward-sloping yield curve sends the message of less economic uncertainty to investors.

With two cuts as the current consensus in 2025, we expect a continuation of normalizing yields as short-term rates decline further.

A Positive Yield Curve, Two Years in the Making



The Fed is Telling One Story with Yields Telling Another



Source: FactSet (charts). As of December 31, 2024.

2025: A Pivotal Point in Markets

Economic data was resilient throughout 2024. With the U.S. presidential election behind us, markets have less uncertainty and can focus on fundamentals going forward.

Valuations remain elevated with the S&P 500 trading at a 24.9x price-to-earnings ratio, above the 10-year average of 18.8x. In fixed income markets, credit spreads are near all-time tights; investment grade spreads +118 bps and high yield spreads are +320 bps, relative to the ten-year averages of +130 bps and +451 bps, respectively.

Heading into 2025, expectations for continued strong performance remain high. The 2025 earnings per share estimate for the S&P 500 of $275.24 (15% y/y growth) is the highest since FactSet began tracking in 1996. We believe high single digit earnings growth is achievable for the index in 2025, near the 10-year average of 8%.

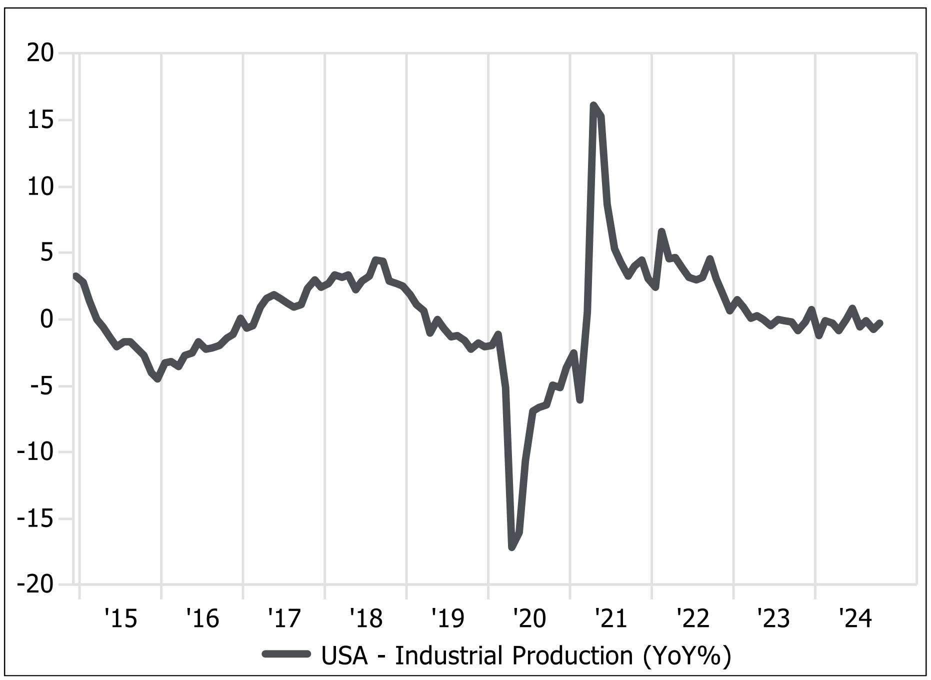
Manufacturing Reshoring and International Tariffs in 2025

In late 2023, Boston Consulting Group reported that more than 90% of North American companies relocated production and sourcing over the past five years. From 2018-2022, U.S. imported goods from China declined by 10% and rose 18% from Mexico, 44% from India, and 65% from the 10 countries in the Association of Southeast Asian Nations.

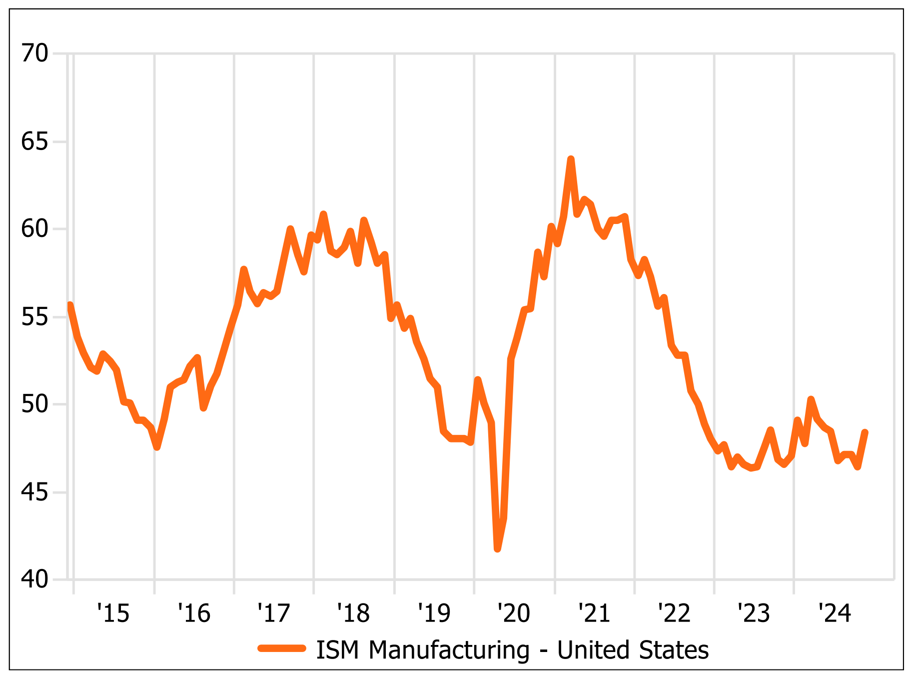
President-elect Donald Trump has said that he plans to implement and increase tariffs on goods imported to the U.S. from around the world. He has mentioned putting a 25% tax on imports from Mexico and Canada, along with increasing tariffs on imports from China by 10%. In addition to tariff policy, the next administration is aggressively seeking better pricing from trade allies and global supply chain efficiencies.

A reshoring of manufacturing to or near the U.S. will be a result of increased global tariffs from the new administration. Overall, tariffs will be mixed and likely not lead to sustained levels of increased inflation on U.S. goods.

Industrial Production is Likely to Improve From A Reshoring of Manufacturing



U.S. Manufacturing Data Appears to Have Bottomed and is Showing Improvement



Source: CNBC. As of November 25, 2024.
Source: FactSet (charts). As of December 13, 2024.
Source: Boston Consulting Group. As of September 21, 2023.

The Trump Administration: Will Deregulation Lead to an M&A Boom?

Initial public offering (IPO) and merger and acquisition (M&A) activity has been muted ever since 2021. Increased levels of inflation and borrowing costs, election uncertainty, and strict regulation have kept the M&A market quiet.

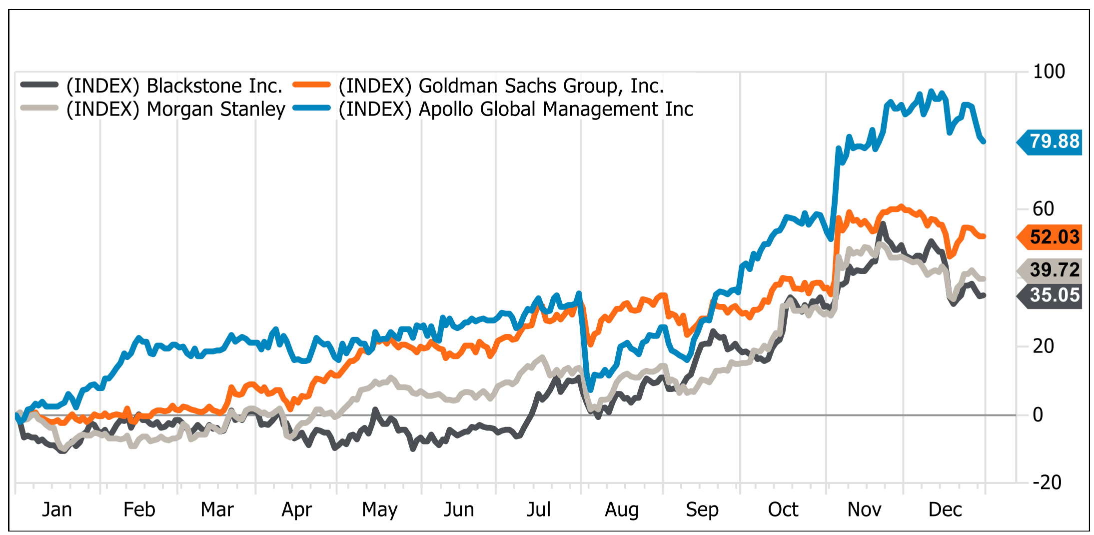
In 2024, we learned that investment banks have a vast M&A and IPO pipeline but are waiting for the right environment for dealmaking. David Solomon, CEO of Goldman Sachs, noted that M&A volumes are currently 13% below the 10-year averages – an improvement from being down 25% across the first nine months of 2023. Solomon noted that muted M&A activity has been the result of a strict regulatory environment.

2025 will likely bring lower regulation, improving the M&A and IPO market. Also, clarity surrounding bank regulation and capital requirements will ease concerns and likely improve the overall functionality of the major banks.

The Number of IPOs and IPO Proceeds Lagged Previous Six-Month Periods

Source: KPMG. As of June 2024.

The Top Investment Banks and Asset Managers Performed Well in 2024



Source: FactSet (chart). As of December 31, 2024.
Source: Goldman Sachs. As of October 13, 2024.

Where Are Companies Investing?

Chief technology officers (CTOs) are reinvesting company cash flows in two areas: artificial intelligence (AI) and cybersecurity. In 2024, Sundar Pichai, CEO of Alphabet, mentioned that under-investing in these emerging technologies is a much larger risk than over-investing.

Microsoft, Alphabet, Amazon, and Meta accounted for 25% of the S&P 500's total capital expenditures in 2024, up from 10% in 2019. In total, these four companies are expected to have grown capital expenditures by 46% in 2024; Microsoft is atop the list, growing capex over 58%. In absolute terms, Amazon is the leader, investing over $72 billion back into its business.

The second piece is cybersecurity. Companies with vast amounts of proprietary, private data cannot afford to lose this sensitive information. 70% of breached organizations have stated that the attack caused significant or very significant business disruptions. Cyber attacks will not slow anytime soon and only become more costly; the estimated annual cost of cybercrimes worldwide is expected to be over $13 trillion by 2028, from $9 trillion today.

We believe investments in AI and cybersecurity will likely remain robust in 2025. Companies are not willing to fall behind competitors in the race for AI while needing to protect and encrypt data at the same time.

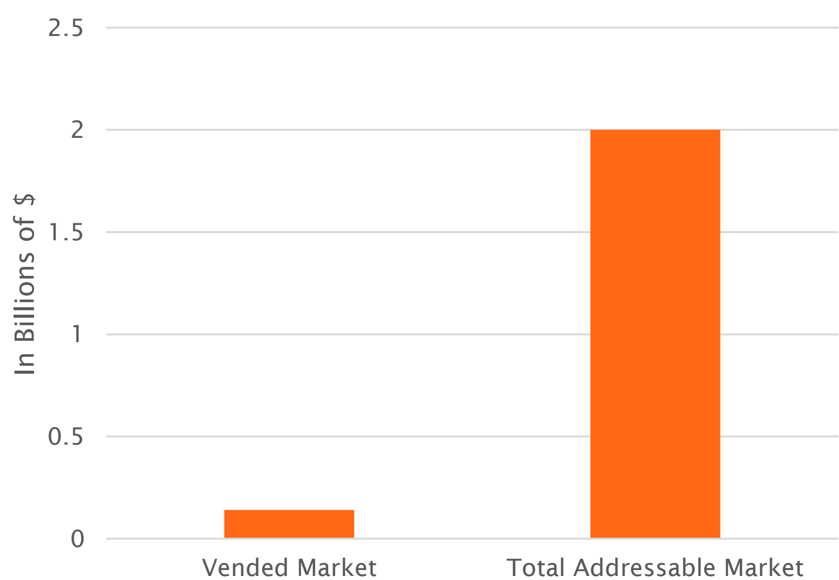
Source: Alphabet. As of July 23, 2024.

What Will Be the Bigger Market, Cyber or AI?

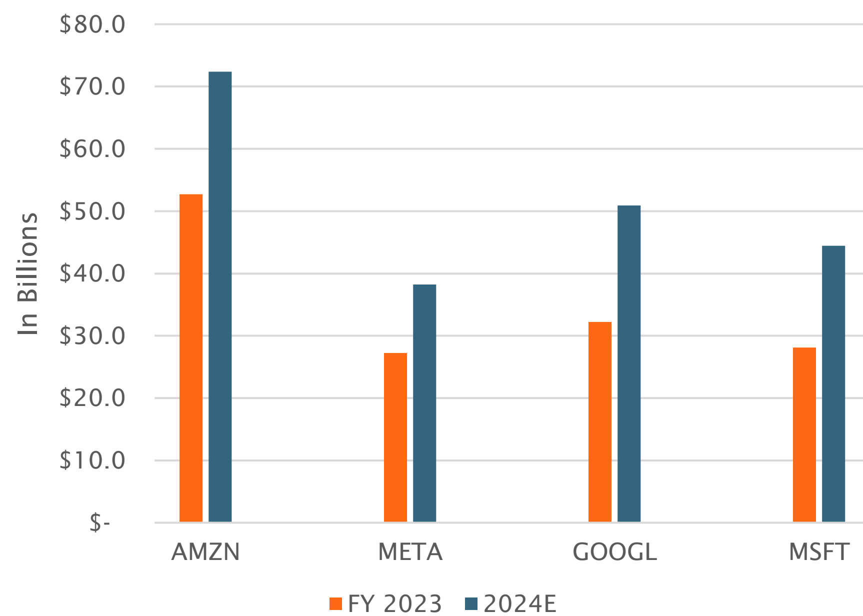
We believe the cybersecurity market could be larger than AI. Data breaches are becoming more frequent, expensive, and an increased area of focus for corporations and governments around the world. The CrowdStrike outage from July proved just how crucial cybersecurity is – although it was an IT-related outage, 8.5 million devices crashed worldwide, and damages totaled north of $10 billion. Delta was one of the most affected companies, cancelling over 7,000 flights and incurring $550 million in expenses and lost revenue. As a result, it is likely that companies will diversify cybersecurity to lower widespread risk, along with focusing on the top providers in the industry.

New and innovative AI capabilities are still being unlocked. Generative AI has shown the ability to summarize text, formulate ideas, anticipate decisions and enhance manual processes for users. Apple Intelligence installed in Apple's newest product line will be the first time mass-scale AI is put in the hands of consumers, and findings are yet to be known. The hyperscalers are prioritizing securing a first-mover advantage and monetizing AI ahead of competition.

The Cybersecurity Market May Reach $2 Trillion, 10x 2021 Levels



The Top Four Hyperscalers Likely Grew Capex 46% y/y in 2024



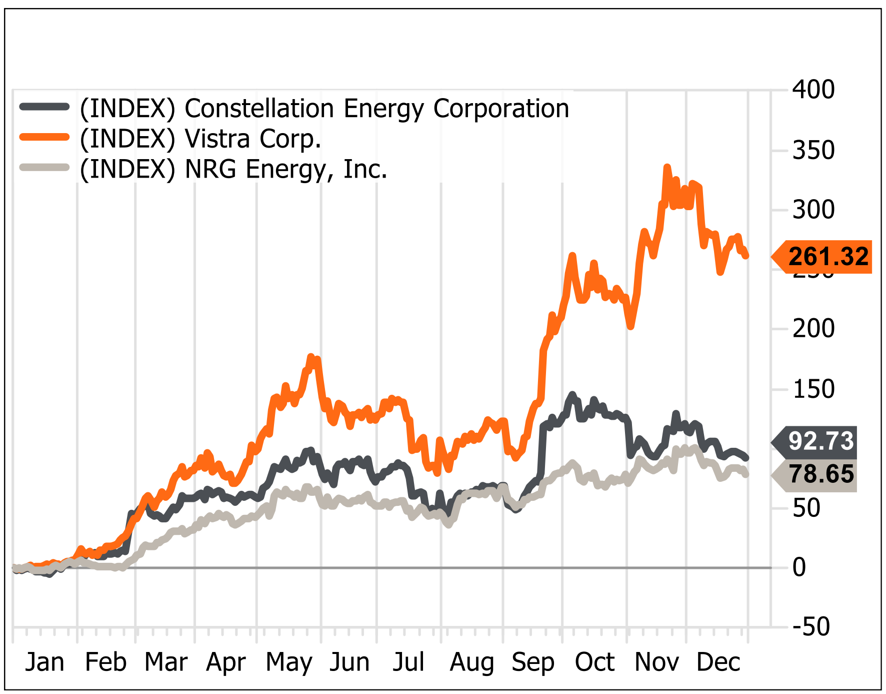
Source: McKinsey (chart). As of October 27, 2022.
Source: FactSet (chart). As of December 18, 2024.

The Non-Conventional Winners from an AI Boom

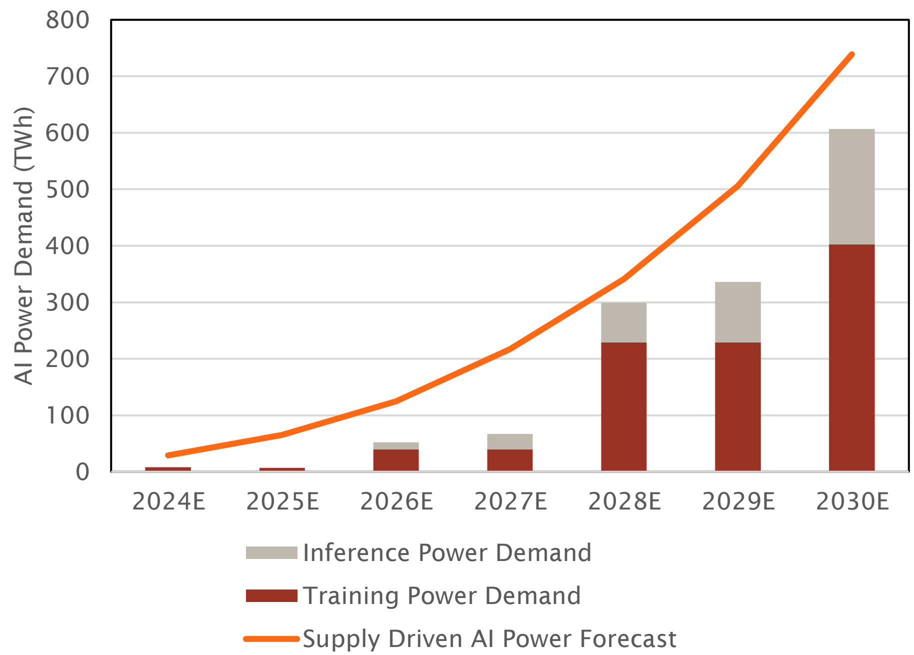
Mass acceptance of AI directly benefits the technology and semiconductor companies that are at the forefront of AI creation, but many other sectors and industries are going to see a boost to demand. The utilities sector gained 18% in 2024 given the enhanced need for data centers and power generation. Industrial companies, such as Eaton and GE Vernova, have exposure to the buildout of data centers and power generation equipment, which will be needed to support an AI economy. Healthcare was a laggard in 2024 but is going to see vast changes to drug discovery, patient diagnosis, and efficiencies from implementing new technologies into medical processes.

It will not only be the mega-cap technology companies benefitting from AI. Consulting firms, such as Accenture, will see a boost in demand for their services in helping corporations navigate a new technological landscape. Oil field service companies, such as Schlumberger, will offer advanced capabilities to support drilling and oil exploration. Investing outside the obvious AI-correlated sectors could be a way to generate excess returns as AI advancements persist.

AI-Exposed Utilities Performed Well in 2024



Generative AI Power Demand Could Grow 8,050% By 2030



Source: FactSet (chart). As of December 31, 2024.
Source: Wells Fargo. As of May 21, 2024.

Diversifying Portfolio Exposure in 2025

Compared to institutional investors, individual investors are under-allocated to alternative investments. The average individual investor allocates 3% to alternative investments, whereas endowments allocate 57%. Research has shown that adding alternatives to a diversified portfolio improves return while lowering volatility.

Private markets provide investment opportunities in sectors of the economy that are difficult to gain exposure to in public markets, and there are many emerging themes across private markets in 2025. Investments in data centers and critical infrastructure, healthcare and nutrition, as well as royalties are industries catching our attention.

Alternative investments are not suitable for all investors and can result in higher return potential but also higher loss potential. Alternative investments are speculative and involve a high degree of risk and may only be available to eligible investors.

Source: Blackstone. As of September 2024.

Alternative Investment Industries to Watch in 2025

North America data center inventory grew by 24% y/y in Q1 2024, adding 807.5 megawatts of power across Northern Virginia, Chicago, Dallas, and Silicon Valley. High demand and low supply of data centers have prices skyrocketing; in North America, the average asking rates for 250-500 kilowatts of power grew 20% y/y in Q1 2024. Advancements in AI and grid capabilities will continue increasing demand for data centers across the globe.

The global health and wellness market is estimated to be worth $1.8 trillion. The industry is growing nearly twice as fast as the global economy, with products like fitness wearables and health supplements becoming more prevalent. 50% of Gen Z consider fitness a high priority, and younger generations are focusing on their health more than ever.

Royalties have an estimated market size of $2 trillion. The asset class is comprised of the underlying revenue performance of an asset, such as a music catalog, patent, or franchise. Royalties have a low correlation to the broader economy, stable income streams, and attractive cash yields.

Visualizing the Coming Power Demand Surge in the U.S.

3%

Data centers' current share of total U.S. power demand

160%

The expected growth in data center power demand (excluding cryptocurrency) between 2023 and 2030

8%

Data centers' 2030 estimated share of total U.S. power demand

Alternative investments are not suitable for all investors and can result in higher return potential but also higher loss potential. Alternative investments are speculative and involve a high degree of risk and may only be available to eligible investors.

Source: CBRE. As of June 24, 2024.
Source: Partners Group. As of December 9, 2024.
Source: Mannatree. As of September 10, 2024.
Source: Goldman Sachs (chart). As of April 28, 2024.

What Was Old, Is New Again

The Covid-19 pandemic exacerbated a shift to remote work, online shopping, and extinguished in-person events. The belief was that the economy shifted to a new normal characterized by a virtual world, but it seems that this is not the case.

Shopping malls are packed, concert venues are full, cruise ships are booked, and even relics such as Barnes & Noble are making a resurgence. Consumers are returning to their pre-pandemic behaviors, looking to leave the virtual world for live experiences.

We see these trends continuing into 2025. Mall and amusement park traffic, in-person events, and older hobbies such as tangible books and film photography are becoming popular once again, all supported by a healthy and spending U.S. consumer.

A Return Pre-Pandemic Activities, Thanks to a Spending U.S. Consumer

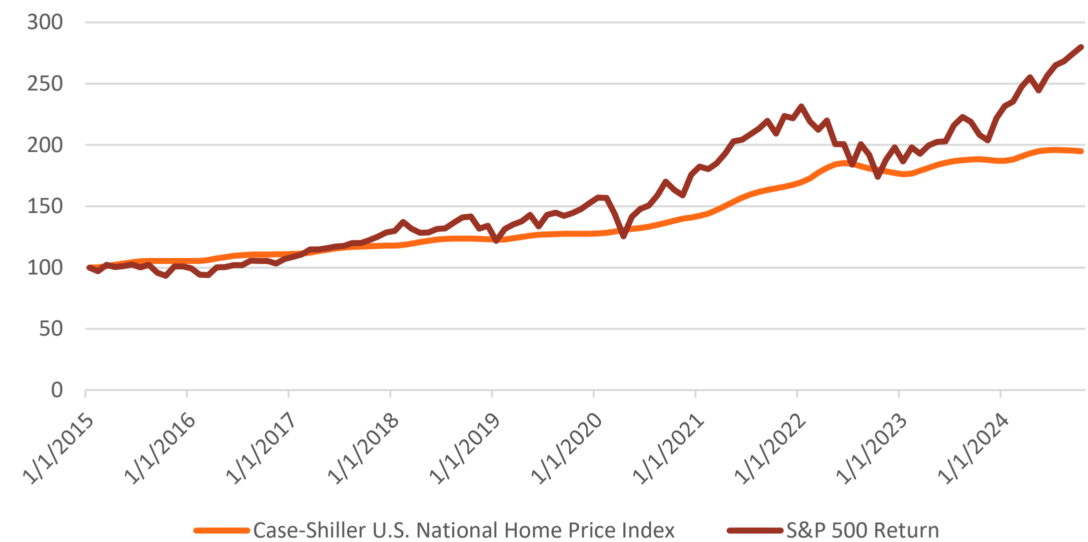
J.P. Morgan projected that 35.7 million passengers traveled on cruise ships in 2024, 6% above pre-pandemic levels. Travel and discretionary spending has risen in part due to the spending capacity of Millennial customers growing 49% since 2019. Today, the average net worth for an individual under 40 is ~$259K.

Through the first half of 2024, U.S. store openings outpaced closures by 20%. National retail vacancy rates held steady at 4.1%, and the demand for retail space has surged by 54 million square feet over the past year, led by the food and discount retailer industries. Brick-and-mortar stores were thought to be past time but have been supported by a spending, growing consumer base.

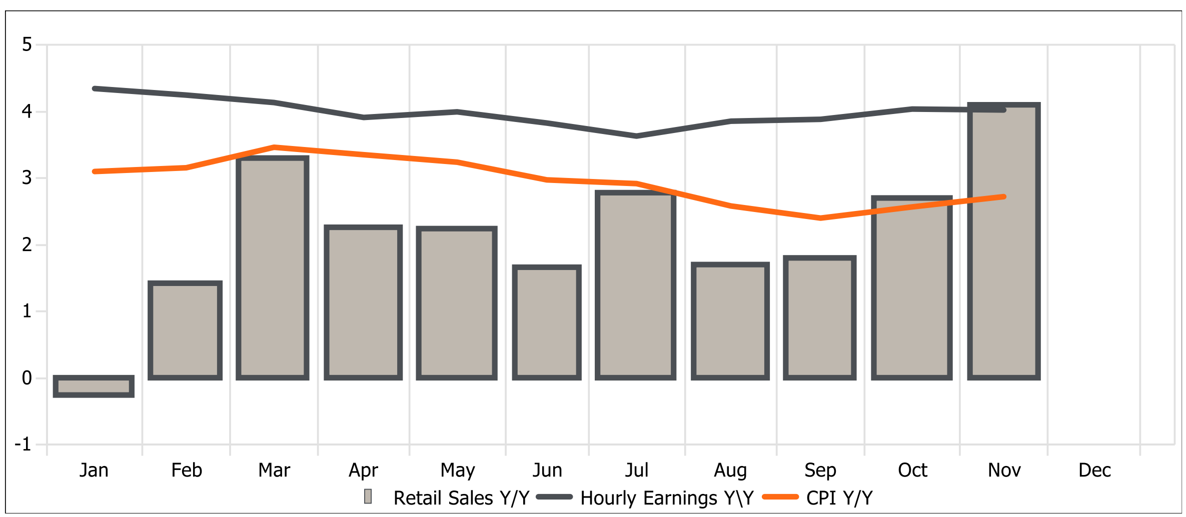
Consumer-exposed companies confirm our belief that the U.S. consumer is alive and well. Wage growth is exceeding inflation, with slowing price increases and a solid labor market. The wealth effect from higher home and stock prices is being realized across the economy in the form of continued spending.

We believe the U.S. consumer will continue spending on discretionary goods and services in 2025, ultimately supporting a continued expansion of the U.S. economy.

The Wealth Effect, Higher Stock and Home Prices, Have Assisted Robust Consumer Activity



Real Wage Growth Results in Growing Retail Sales



Source: J.P. Morgan. As of June 7, 2024.
Source: Colliers. As of July 10, 2024.
Source: FRED St. Louis (charts). As of December 31, 2024.
Source: FactSet (charts). As of December 31, 2024.

Six Themes to Watch in 2025

With easier monetary policy, expansionary fiscal policy, and declining inflation, we are seeking cyclical themes that may benefit from an economy growing above trend.

Power and Grid Infrastructure

AI adoption will require a vast amount of energy production. The U.S grid has not been upgraded in 40 years, and new forms of power will likely be needed, such natural gas and nuclear energy.

1

Cybersecurity

In 2024, the average data breach cost $4.9 million in recovery expenses. With more data online today than ever before, protecting and securing data is one of the most important areas of focus for C-suite executives.

2

Housing

Home buyers are eagerly awaiting lower mortgage rates. Five million millennials are looking to be first-time home buyers, and the U.S. has underproduced home building for 14 years. The result is little supply, with much demand.

3

Normalizing Yield Curve

Lower short-end yields, and higher long-end yields, will assist the major banks in net interest income production. Investors have not seen net interest income growth for over two years, and the major banks are one of our top picks in 2025.

4

The American Consumer

Retail sales remain robust, rising 4% y/y in November. Wage growth is outpacing inflation, and the wealth effect is being felt through a well-performing stock market and record-high home prices.

5

International Opportunities

Increased U.S. tariffs on imported goods will impact China, Mexico, Canada, and others. India is our favorite opportunity, with the fastest-growing economy in the world and a pro-business government.

6

Source: J.P. Morgan. As of August 1, 2024.

Key Sectors to Watch in 2025

We believe sector performance in 2025 will be driven by areas of high investment and consumer resiliency. Companies well-positioned to benefit from improved price stability, technological innovation, and an economic expansion are likely to outperform.

The Major Financials

Regulation is the turning point for financials in 2025. A slow IPO market and muted M&A activity are likely to flip this year. Also, major banks have had little to zero net interest income growth over the last two years. More rate cuts this year should steepen the yield curve and provide banks with more spread to gain in terms of borrowing versus lending. A healthy consumer, growing loan demand, and improving deposit base will further support the financials.

Power and Grid Industrials

Tariffs, reshoring, and power demand are the drivers for this industry. The Trump administration is likely to be tough on foreign goods, bringing industrialization back to the states. The need for more power to support AI advancement is real – the hyperscalers are in a race to sign deals with utility providers to service their data centers. An industrial revolution is taking place in the U.S. given these major developments.

Selective Consumer Activity

We learned in 2024 that American consumers are alive and well but are being selective in their preferences. The top food and retail companies had a strong 2024, while lower-end retail and high-end discretionary items struggled. In 2025, the consumer will remain healthy while also spending in a constructive manner. Discretionary is likely to continue to outperform staples, with the consumer still preferring experiences (services) over material goods.

Sector	Total Return	
	2023	2024
Communication Services	50.86%	35.46%
Consumer Discretionary	40.48%	27.69%
Consumer Staples	-0.45%	10.94%
Energy	2.97%	4.40%
Financials	11.63%	29.99%
Health Care	2.36%	0.70%
Industrials	17.87%	18.50%
Materials	12.57%	0.32%
Real Estate	11.95%	4.11%
Technology	57.51%	24.90%
Utilities	-7.17%	21.52%
Total	***24.73%***	***24.01%***

2023 and 2024 brought investors above-average returns in public equity markets. Led by technology and communication services, we welcome a broadening of market participation in 2025. Lower interest rates should benefit a wide range of sectors, such as the ones mentioned above. Look for the laggards, such as health care, real estate, and energy to see a turnaround in 2025.

Source: FactSet (table). As of December 31, 2024.

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Thank You

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All returns data and statistics are sourced from FactSet, unless otherwise noted. Returns data as of December 31, 2024.