INVESTMENT OUTLOOK
A PEAPACK PRIVATE PUBLICATION

FOURTH QUARTER 2024:
GOLDILOCKS MAKES A COMEBACK

To have a comeback, you have to have a setback.
-Mr. T

It is natural that authors come to regard the characters they create with affection and, perhaps, a touch of nostalgia. It has been some years since we spied our beloved Goldilocks slinking into retirement, feeling as she did that there was no place for her in a world transformed by Covid and the topsy turvy economic roller coaster that ensued.

But we cannot deny that we have missed her and so, as we do with successful movie franchises, we are bringing her back for *Goldilocks: Part 2*, the sequel. She was gracious enough to sit down with us for an interview; the transcript that follows has been edited for clarity.

IO: You've been absent from the US silver screen for a number of years now. How did it feel to retire, and how does it feel to return?

Goldilocks: I retired when it became clear that there was no role for me.

When Covid hit, there were huge job losses. Supply chains crumbled. The stock market plummeted. The economy fell into recession. These conditions were met with extraordinary fiscal and monetary stimulus programs. The economy boomed. So did inflation. Employees were scarce. Demand for goods soared.

Only recently have conditions in the labor market achieved a balance, and price pressures abated significantly, for me to be able to appear in public again. And, honestly, I'm so glad to be back—but I'm not sure for how long.

MARKETS COOL

At the table in the kitchen, there were three bowls of porridge. Goldilocks was hungry. She tasted the porridge from the first bowl. "This porridge is too hot!" she exclaimed.
-Robert Southey

IO: Financial markets exhibited a notable cooling in the fourth quarter. How do you explain that?

Goldilocks: Simple. Markets were simply too hot earlier in the year. Expectations were too high. US election results initially gave a lift to equities, but that euphoria gave way to concerns about potential inflationary pressures from policy initiatives around immigration, trade/tariffs, and deficit spending. As a result, interest rates rose and bond prices fell. The dollar strengthened, weakening overseas market returns. Real estate securities also suffered from higher interest rates.

Asset Class	Index	4th Quarter Results	Full Year Results
US Large Cap Stocks	S&P 500 Total Return	2.4%	25.0%
US Large Cap Stocks	S&P 500 Equal Weighted	-1.9%	13.0%
US Small-Mid Cap Stocks	Russell 2500	0.6%	12.0%
International Developed Markets Stocks	MSCI EAFE	-8.1%	3.8%
Emerging Markets Stocks	MSCI EM	-8.0%	7.5%
Real Estate Securities	MSCI US REIT	-6.1%	8.8%
Commodities	Bloomberg Commodities Futures	-0.5%	5.4%
Bonds	Bloomberg Barclays US Aggregate	-3.1%	1.3%
Cash	FTSE USBIG 1-Month Treasury Bill	1.2%	5.4%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

IO: Looking at 2024 as a whole, it was a robust year for financial markets. How much of that strong performance do you attribute to your calming presence on the scene?

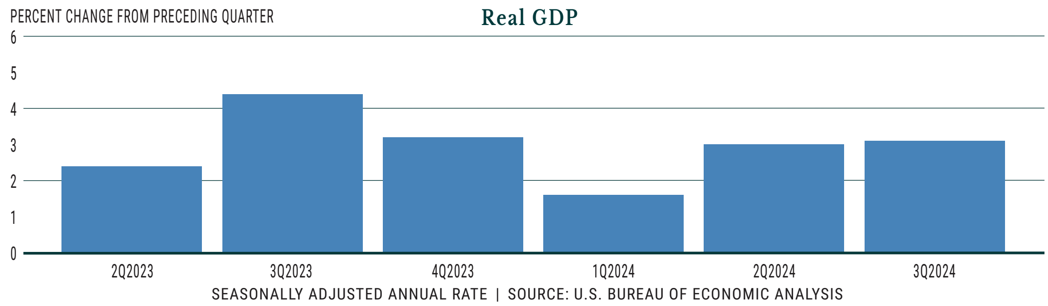
Goldilocks: Modesty obliges me not to take full credit, but it's true that moderating inflation, a healthy labor market, and a less restrictive Fed all contributed to market-friendly conditions. Of course, this environment gave rise to domestic economic conditions that warrant the sobriquet of American exceptionalism. The US focus on technology innovation and adoption produced vastly superior investment returns for artificial intelligence-oriented firms, driving a massive 25% rally for US large cap stocks. Most other asset classes delivered lesser mid-single digit returns. Fixed income securities generated very modest returns, as higher interest rates cut into bond prices.

THE JUST-RIGHT ECONOMY

Goldilocks was very tired. She went upstairs. "This bed is too hard! This bed is too soft! This bed is just right!"
-Robert Southey

IO: For much of 2023 and 2024, the conversation amongst economists centered on whether the Fed would be able to engineer a soft or a hard landing as it raised interest rates to reduce inflation. That is, could it gradually slow the economy to a sustainable, noninflationary pace, or would it push the economy into recession? What's your assessment of the Fed's performance?

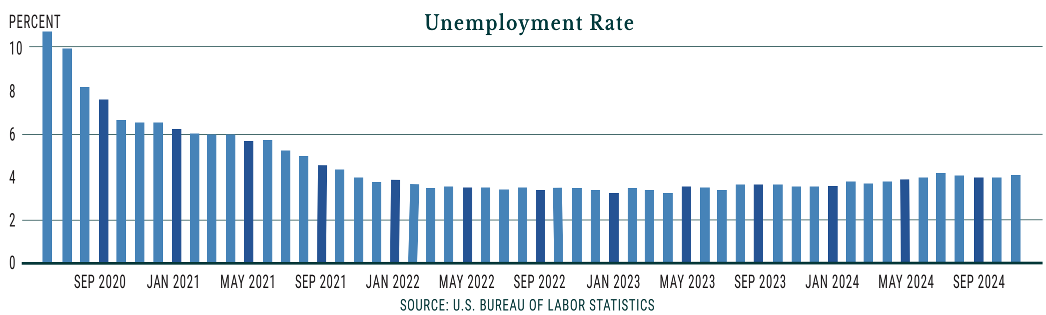
Goldilocks: The early read is that the Fed has gotten it just right. For four of the past five quarters, US GDP has grown at an annualized rate of 3% or better—well above the long-term post-global financial crisis trend rate of 1.8%.



IO: The Fed has a dual mandate: full employment and price stability. What's the outlook for each of these?

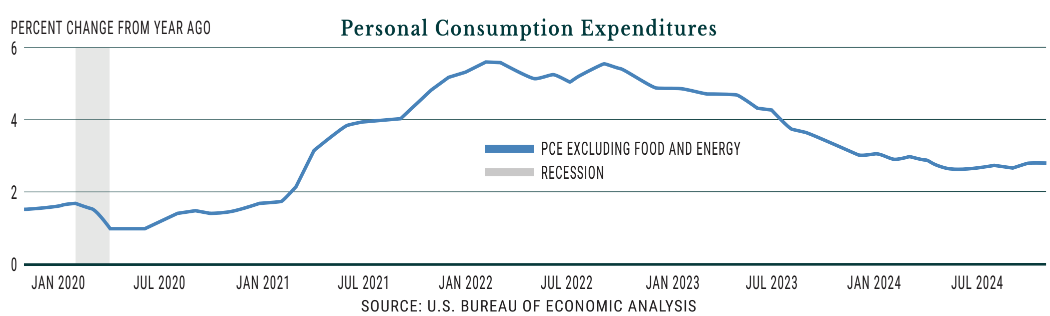
Goldilocks: On the employment issue, the Fed appears to have achieved a good balance. The enormous shortage of workers and unfilled jobs following the pandemic has subsided, and with it wage inflation has been tempered. At the same time, new entrants have joined the work force and the supply of and demand for workers appears to be in equilibrium.

The unemployment rate, at 4.2%, is well below long term average levels and, after dipping to historic lows after the pandemic, has held steady in a narrow range for the last six months.



Other measures of the labor market similarly suggest it is in a healthy state. Weekly new unemployment claims remain at low pre-pandemic levels; annualized wage growth is hovering around its 4% long term average, and monthly nonfarm payroll growth has averaged 180,000 new jobs.

On the inflation front, the Fed has made substantial progress from elevated inflation levels of 18 months ago. The Fed's preferred inflation measure, core Personal Consumption Expenditures, has dropped significantly from its peak near 6% in early 2022. The most recent reading was 2.8%.



However, the Fed cannot rest on its laurels. Its inflation target is 2%, and as the graphic above makes clear, it made little progress towards the goal in 2024. While the labor market has ceased generating inflationary pressure, the services economy continues to exhibit price increases.

IO: With inflation seemingly 'sticky' above the Fed's target, aren't you concerned that further economic strength and potential policy initiatives could push inflation higher again?

Goldilocks: There's an absolutely rad countervailing force to inflation, and that's productivity. Labor productivity is defined as economic output per unit of labor, and it's been on fire lately. While the average productivity growth over the past 20 years has been 1.5%, it has exceeded 2% for five of the past six quarters. The more productive we are, the faster the economy can grow without generating inflation.

IO: You make it sound like this is a just-right economy.

Goldilocks: Almost. That's why I'm here. But the strong growth seen in the service sector is in notable contrast to weakness in the housing and manufacturing sectors. While there are glimmers of an awakening in the housing market, it remains weighed down by high home prices and elevated mortgage rates. And manufacturing activity has been in the doldrums for many months now, as consumer priorities have turned from goods to services.

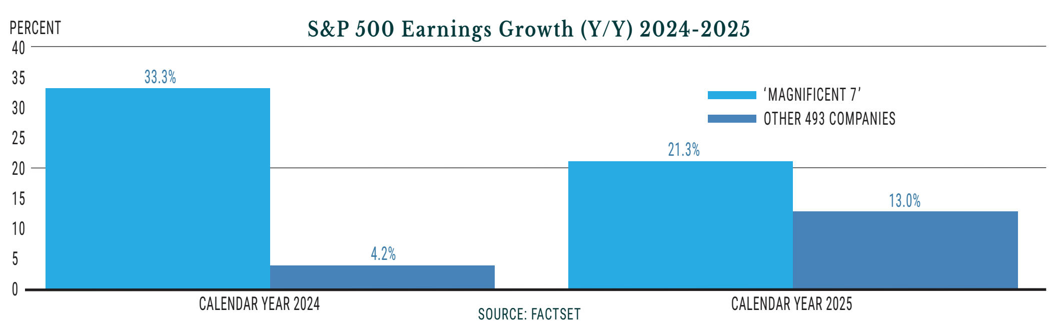
ARE EQUITIES TOO BIG?

Goldilocks was tired now. "This chair is too big!
This chair is too big, too! This chair is just right!" But the chair broke.
-Robert Southey

IO: It's been a tremendous two years for stocks. Especially for US large cap stocks. Especially for US large cap growth stocks. Especially for US large cap growth technology stocks involved with artificial intelligence. Can this continue?

Goldilocks: Earnings are the lifeblood of the stock market. Starting in early 2023, stock prices began rising rapidly, and for 18 months most of that appreciation can be attributed to 'multiple expansion'—investors' willingness to pay more for a given level of earnings—rather than growth in the level of earnings. Earnings growth for the S&P 500 were a scant 1.0% in 2023, according to FactSet, on modest sales growth of 2.0%. It is estimated that earnings in 2024 will have risen a more robust 9.5%, on sales growth of 5.1%. (Over the past 10 years, earnings growth has averaged 8.0%.)

The distribution of 2024 earnings, however, is telling. The 'Magnificent 7' technology companies are predicted to report earnings growth of 33%; the remaining 493 companies in the index will report earnings growth of just over 4% for the year.



For calendar year 2025, analysts anticipate earnings will grow 14.8%. That is a lofty estimate, particularly on top of 2024's healthy growth. It surely suggests a just-right economy that continues to expand at above-trend rates. Interestingly, the earnings growth rate of the Magnificent 7 is projected to decelerate to a still-elevated 21% level, while the non-Magnificent 493 may see earnings growth accelerate to 13%.

These are high expectations. Underlying them are implicit assumptions that the incoming Administration will execute a pro-growth agenda, empowering companies to expand net profit margins to a record 13%.

Even if these enthusiastic projections are met, stocks could face some tough sledding. With the S&P 500 currently trading at 22-23 times expected 2025 earnings, valuations are the second highest in stock market history, according to the cyclically adjusted price-to-earnings (CAPE) ratio. In other words, the 'good news' is theoretically priced in. In fairy tale terms, equities are 'big'. Which means that, should shortfalls occur, downside market volatility could be considerable. The just-right chair could break.

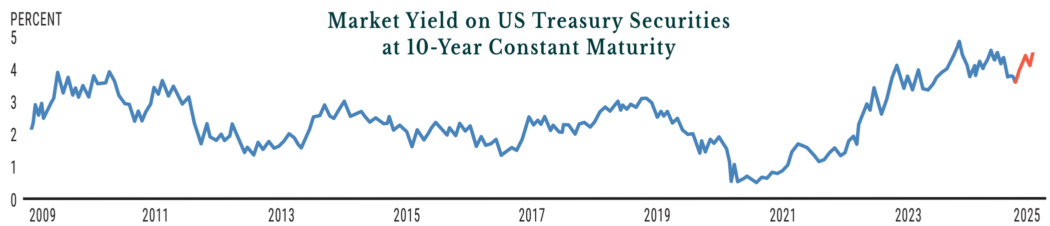
THE BOND MARKET: HIGHER YIELDS ARE STILL THERE

"Someone's been sleeping in my bed!—and she's still there!" said Baby Bear.
-Robert Southey

IO: What's your outlook for the bond market?

Goldilocks: It's informed by historical perspective. I haven't seen my one-time bestie TINA (you remember her—There Is No Alternative—to stocks, because bond yields were so low) for a couple of years now. She was forced into retirement when the Fed raised interest rates in earnest in 2022, thereby creating a valid alternative—bonds!—to stocks. I'm not sure she's permanently retired—never say never—but I don't think she's coming back soon, unless there's a real financial crisis.

The Fed started to cut rates in September, and did so again in November and December. But a curious thing happened. While the short-term Fed funds rate fell, other rates rose. You can see at least two important things in the chart below.



SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (US)

On the far right, you can see that 10-year interest rates have been rising since mid-September 2024, despite those Fed rate cuts, topping 4.5% recently. And you can see that current 10-year interest rates are near the highest levels we've seen since the global financial crisis.

So, from a yield perspective, it's not hard to like bonds. Good yields are still there.

JUST RIGHT, RIGHT NOW

Goldilocks woke up and saw the three bears."Help!"
She ran downstairs and into the forest. She never came back again.
-Robert Southey

IO: You've painted a pretty rosy picture: of an American economy exhibiting exceptional growth, full employment, and inflation tempered by escalating productivity; of a US stock market buoyed by a superior corporate profits outlook and a globally dominant technology sector; of a bond market featuring historically attractive interest rates and solid credit quality. What could go wrong? For how long will things remain 'just right'?

Goldilocks: None of us can predict our own ends, but it is also important to understand that 'just right' doesn't last forever. I hope I have staying power. But I know that the world is fluid. There is nothing inherently stable in economies, in markets, in politics. Change will come; we just don't know when, and in what form.

The most immediate uncertainties we face are the policy changes that are about to be implemented. Reduced regulations and lower taxes (and accommodative fiscal policy generally) are stimulative for the economy, and could accelerate growth. Such prospective growth could push up inflation. Imposition of higher tariffs and changes to immigration policy, including mass deportations, could prove to be inflationary too while potentially slowing economic growth. Uncertainties abound about both the actual adoption of such policies and what their real-world economic impacts would be.

IO: We could add to the uncertainties you noted by citing geopolitical winds of change. Many Western government leaders are barely clinging to power. Alliances are shifting. Wars are still being fought in eastern Europe and the Middle East.

Goldilocks: Yes, we can go on and on. Despite these uncertainties, this is truly an extraordinary moment for the domestic economy and financial markets, with rising consumer confidence and positive investor sentiment. That's not a call to radically restructure portfolios. Investors should not implement dramatic changes to their investments; they should remain focused on their long-term goals, sticking with an asset allocation strategy that reflects their objectives, risk tolerance, and investment fundamentals like earnings and valuation. They should remember that this is but a moment, fleeting, ephemeral, temporary.

IO: Is this your swan song, then?

Goldilocks: I'm not leaving just yet, and I can't say I'll never be back again. But when I do leave, it may be a very long time before I return. So enjoy the moment.

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