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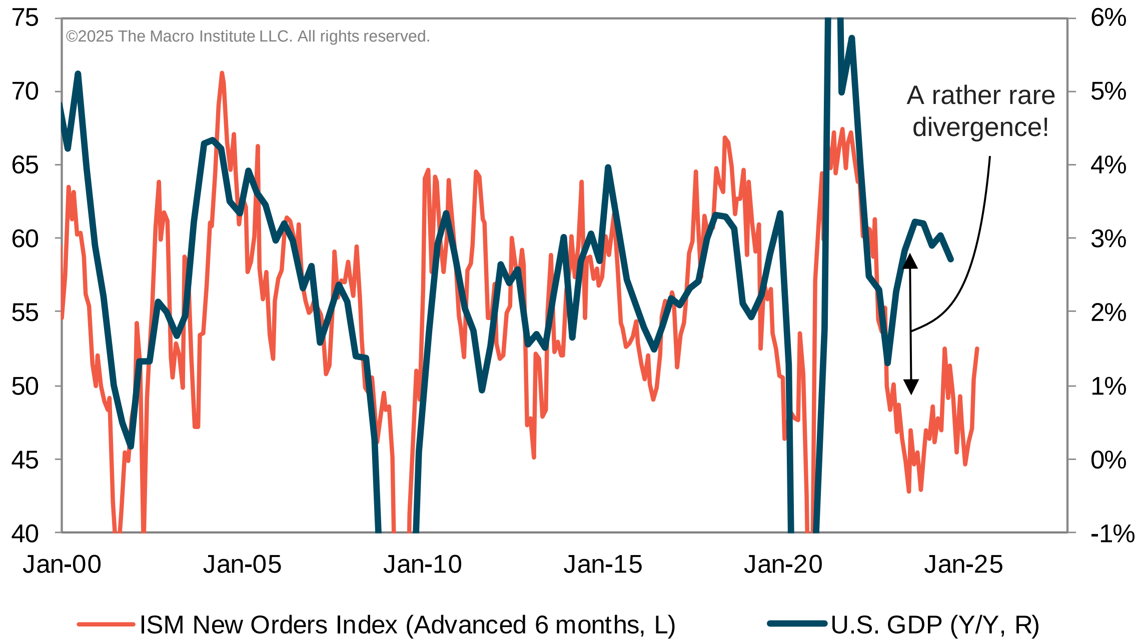
TRAHAN RESEARCH
THE MACRO INSTITUTE

January 6, 2025

An Inflationary Recovery In 2025 … Risks And Opportunities!

It feels strange referring to a backdrop as unusual since most economic cycles are unique. That said, there are quite a few peculiar aspects this time around. First off, few investors have experienced a true soft landing, and this one, until now at least, has been largely due to unprecedented forces (more on that later). Second, we have an incoming administration considering policies that have rarely been used. Meanwhile, one of the largest economies in the world, China, has been desperately trying to reinvigorate economic activity. This is one of the most interesting backdrops I have experienced in my almost-30 years of research.

Leading Indicators Clearly Missed Something This Cycle!



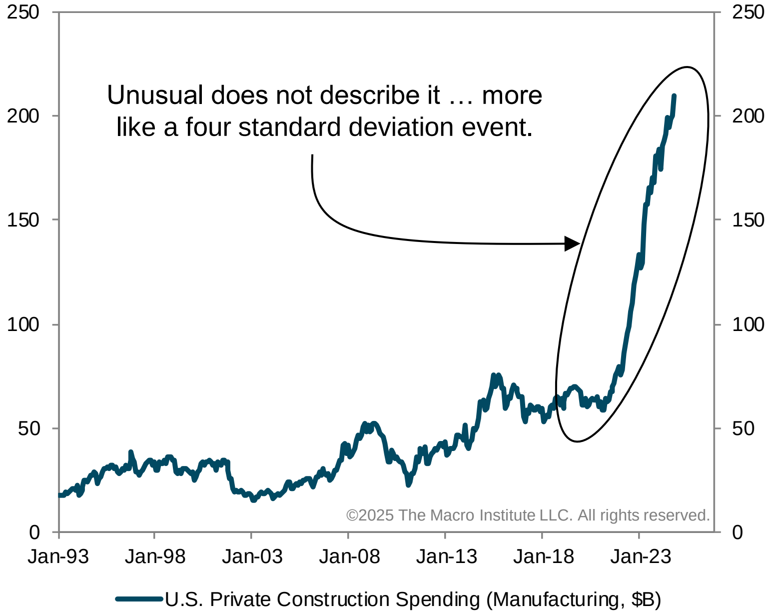
In recent months, we have seen the Fed take a victory lap on their soft-landing achievement, but we suspect that this feeling will sour in 2025. A soft landing is a backdrop where the economy does not generate excess capacity. Now, throw Fed rate cuts into that world and it will quickly lead to a rebound in inflation. Worded differently, many leading indicators of employment are pointing higher for 2025, and the unemployment rate is already only 4.2%. We suspect the Fed will have a light bulb moment sometime this year and will start talking about rate hikes once again. Hence, higher bond yields are likely!

There are a lot of unknowns in this backdrop, and I'm sure we'll see some surprises (tariffs?!). Will the world economy gain steam in 2025 and contribute to the buildup in inflationary pressures in the U.S.? How will the S&P 500 and its heavy growth tilt react to better economic prospects and the opportunities they present in more cyclical parts of the market? There's a lot to tackle. We barely scratch the surface in this report, but we will go more in depth on our Outlook Call this Wednesday at 10:30 am (register here). I think this is one of the most interesting backdrops I have seen in my career. Wishing you all a great year. Best, Francois

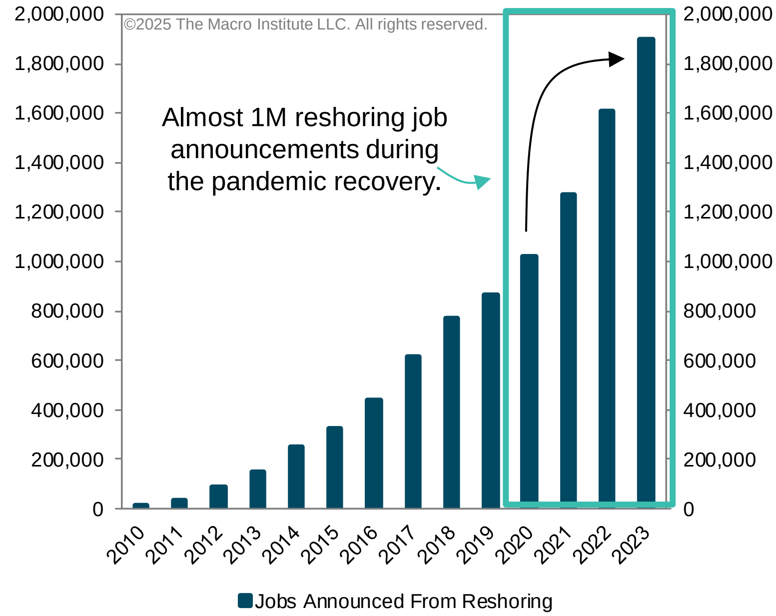
Unprecedented Economic Forces Help U.S. Avoid Recession

If there was space in the title I would have added "thus far" at the end. For now, however, it does meet the definition of a soft landing. However, there are a lot of moving parts behind this so-called achievement. Reshoring certainly played a large role in this story. This includes the benefits from the CHIPS Act, but it is broader than that. The bottom line is that we have never seen private construction soar like this, and that it happened during a Fed tightening cycle makes it even more impressive.

Robust Manufacturing Spend Amid Tightening

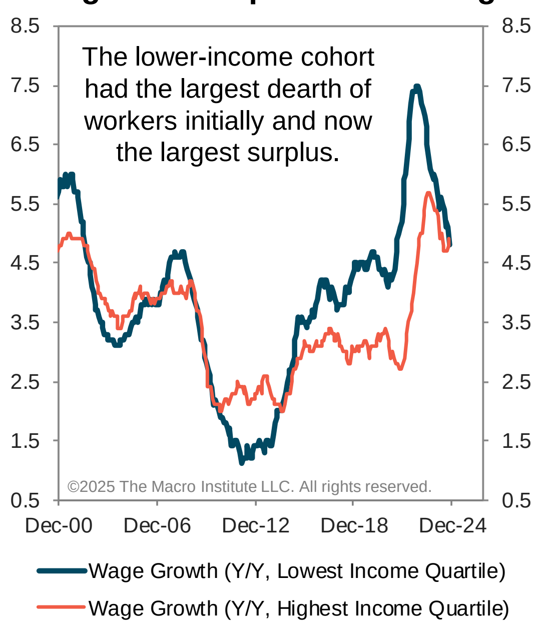


Cumulative Reshoring Jobs Announced

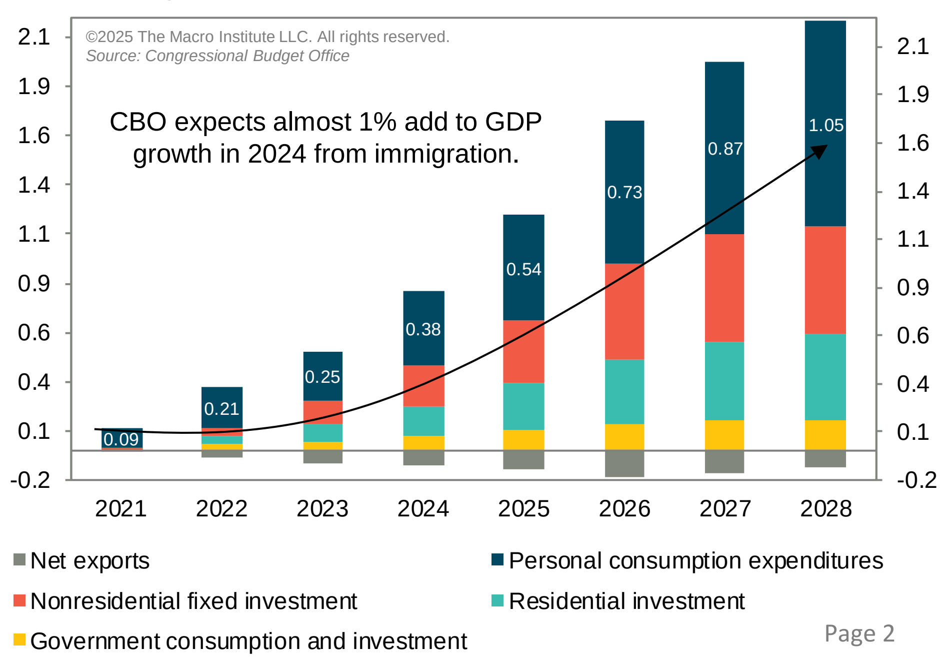


I think everyone is aware of the reshoring story by now. The other big contributor that few have focused on, however, is the contribution to economic activity that came from (mostly illegal) immigration. Many are aware that the surge of undocumented workers in recent years helped contain wage inflation. The Congressional Budget Office estimates that the immigration surge added almost 1% to real GDP growth in 2024. This is not insignificant, and certainly helped the Fed's effort in restraining inflation AND maintaining economic growth. (i.e., achieve non-inflationary growth).

Immigration Helped Inflation Fight



Immigration Also Contributed To Economic Growth



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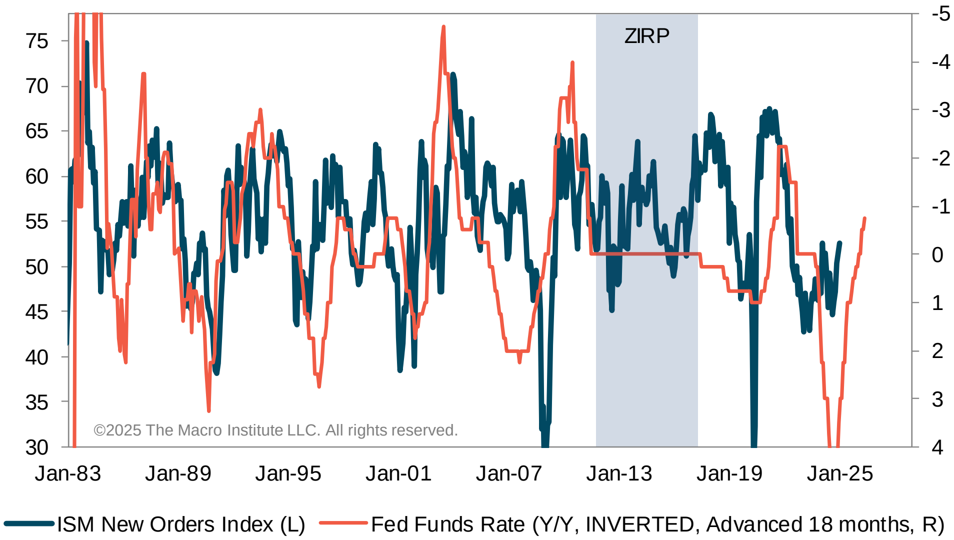
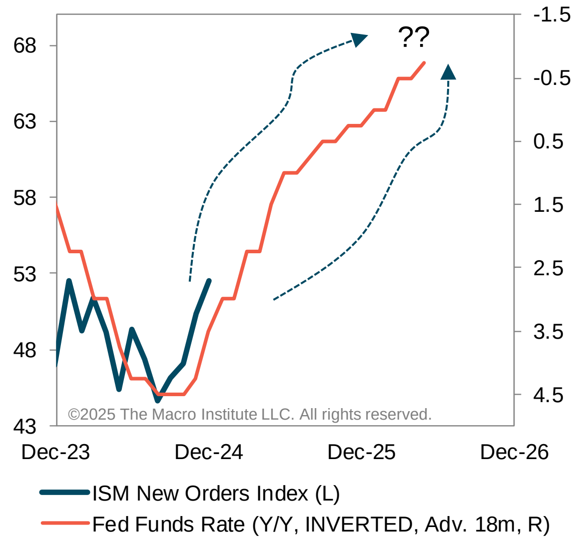
Policy Turns Supportive In 2025 … Expect "Green Shoots" In LEIs!

There were a lot of moving parts influencing the economy during the pandemic recovery. So much so that the leads/lags between changes in interest rates and their influence on leading indicators looked off for some time. As we approach the fifth anniversary of the start of the pandemic, these historical relationships appear to have resumed. Here is what we know – in normal conditions it takes about 18 months for a change in Fed policy to influence LEIs like the ISM New Orders Index. LEIs should start to look better in 2025 and even beyond that. All other things equal, this is bullish.

LEIs Usually Start To Recover ~18 Months After Last Rate Hike

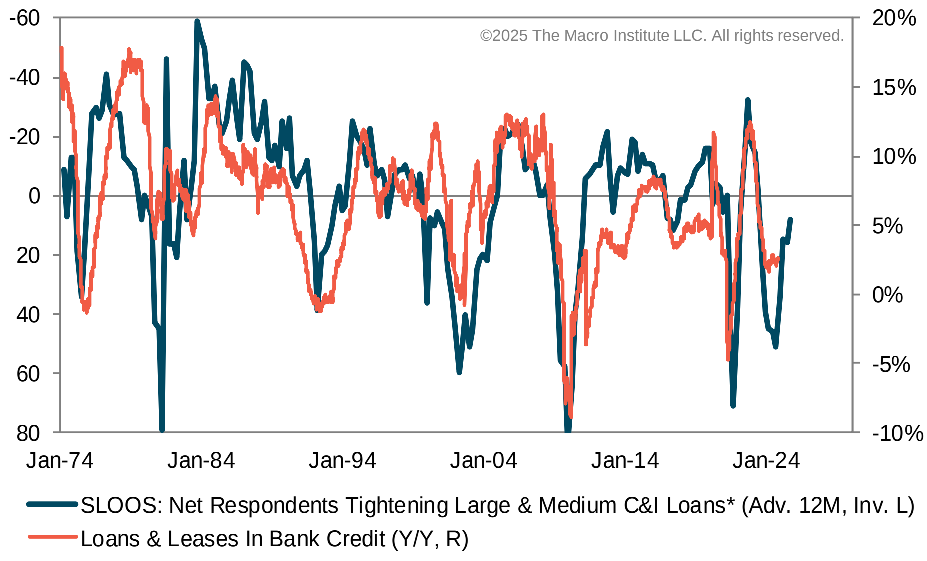


Higher LEIs In 2025?!?



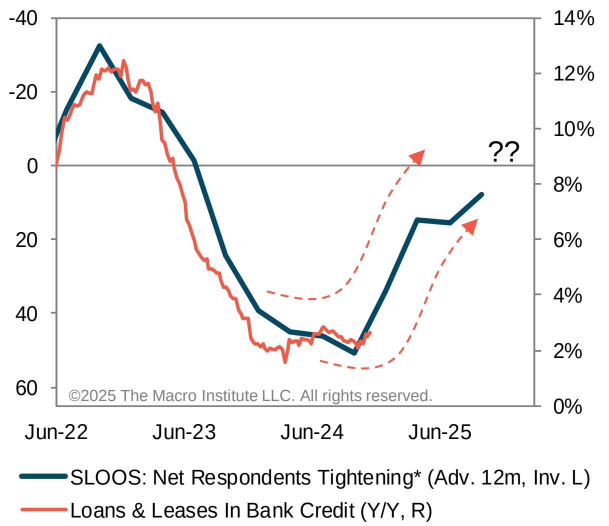
It's not just monetary policy that turns supportive in 2025 – the banking system also looks like it will be additive to economic activity next year. The Federal Survey of Senior Loan Officers (FSSLO) has been pointing to looser lending standards for some time now. With the appropriate leads/lags, it argues for credit growth to intensify in 2025, which would be a first in several years. Support from monetary policy AND lending standards adds up to quite a bit of support for an economy that is already growing at a decent clip … in the context of the last decade anyway. Cumulatively, this is significant.

Loosening Credit Standards Also Supportive



*Spliced with Consumer Loans Pre-1990)

Loan Growth Accelerating In 2025?

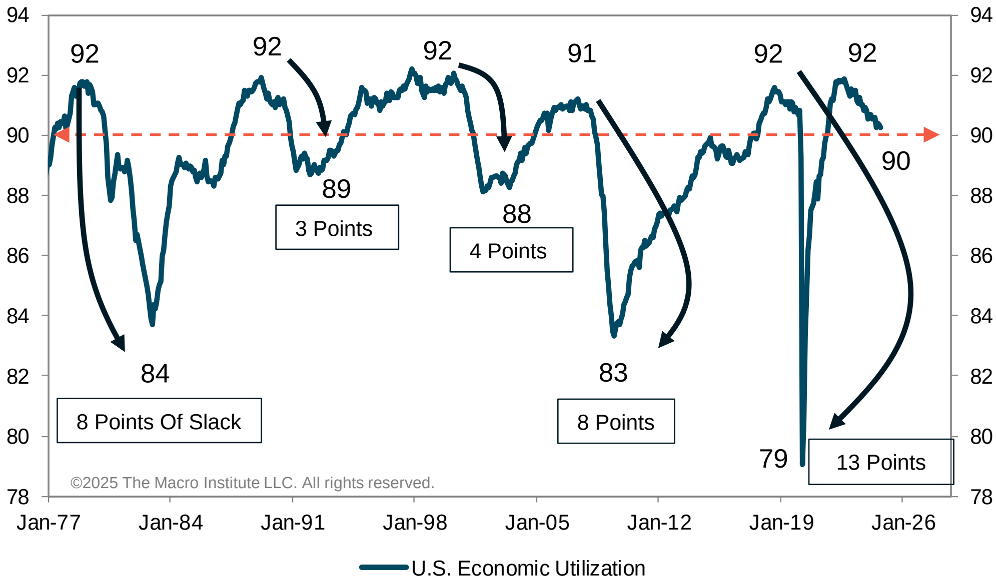


*Spliced with Consumer Loans Pre-1990)

Stimulus And Lack Of Excess Capacity Adds Up To … Higher Inflation!

The stimulus story we reviewed on the prior page is quite bullish when looked at in isolation. That is not how the economy works, however. Here is the most important fact about the current backdrop: there is very little excess capacity available. This is a drawback of a soft landing – you don't get the "recession is a cleansing mechanism for the economy" effect. The output gap is at its most inflationary in almost 40 years and our preferred measure, economic utilization (EU), also sits at inflationary levels. The issue is that all of this is happening in an economy that looks set to accelerate. This isn't good for inflation.

Lack Of Excess Capacity Already Inflationary

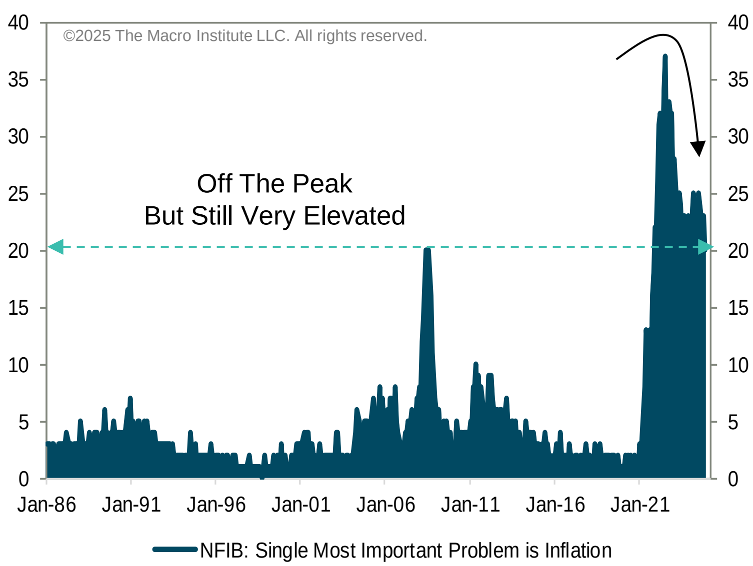


Economic Utilization	Avg. Change In Core CPI
EU Above 90	+1.0%
EU Below 90	-1.3%

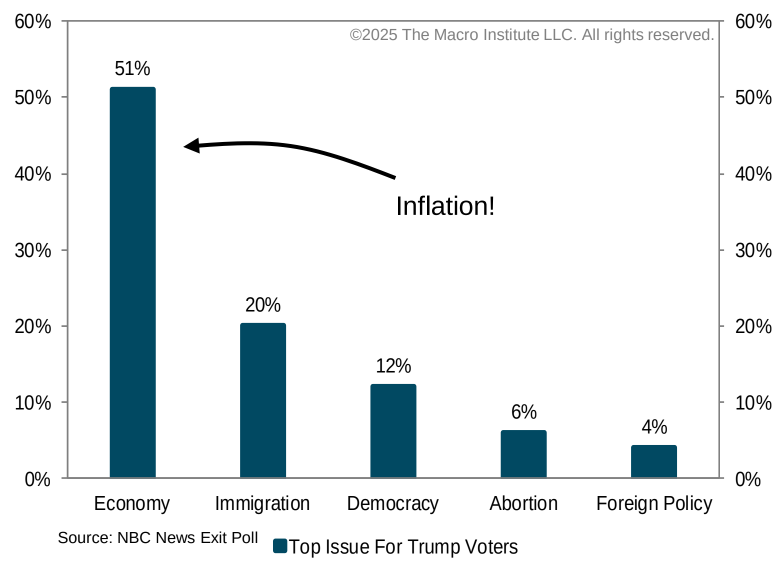
Economic utilization is the extent to which an economy is being used relative to its maximum potential.

Let's sum up the backdrop thus far. The Fed already has cut rates 100 basis points and the FSSLO shows easier lending standards across the U.S. banking system. Considering the appropriate lags, it will be about 18 months before this stimulus starts to show up in LEIs. Again, with no other context it sounds pretty good. This is all happening in an economy that did not slow much, which resulted in a backdrop with little excess capacity. In essence, the business cycle should turn inflationary quite quickly in 2025. Why is this important? There are myriad reasons, but the most significant is the fact that companies AND consumers still see inflation as a problem. In essence, we have not dealt with inflation.

Inflation Still *A Problem* For Small Businesses



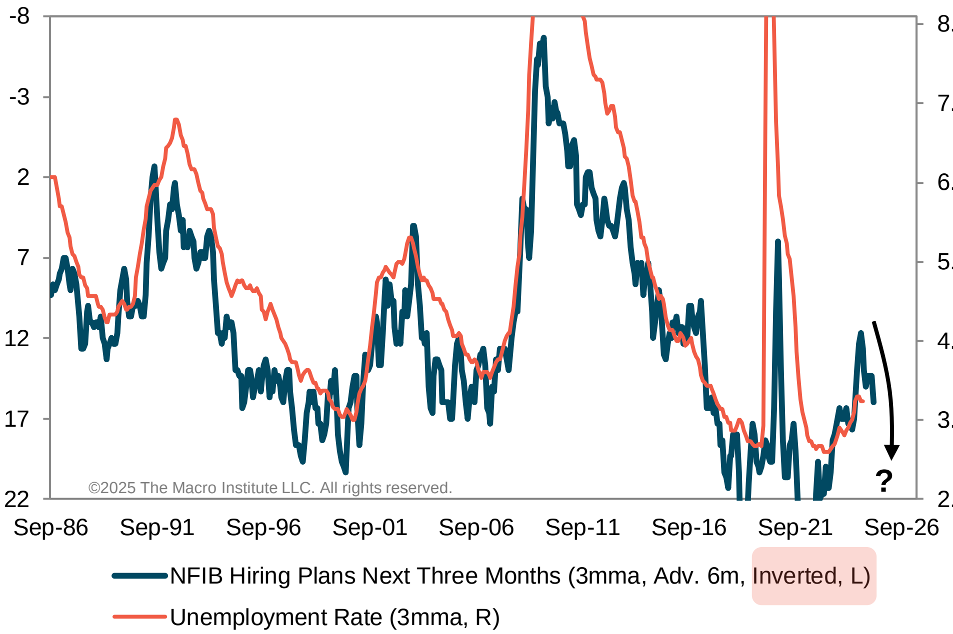
Inflation Still *An Issue* For Consumers



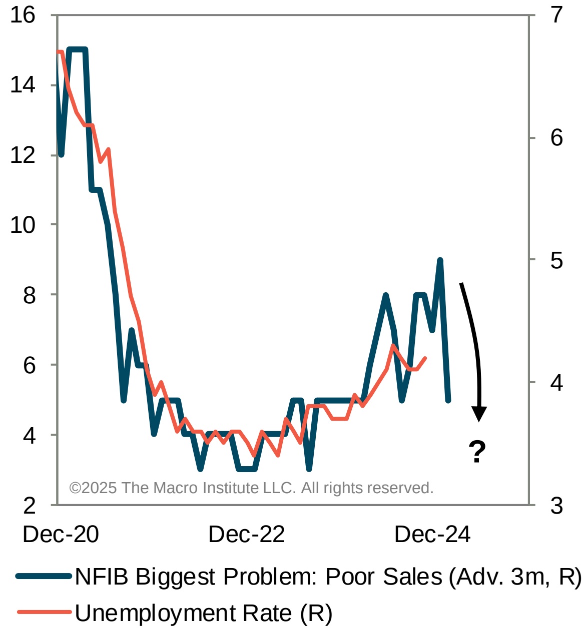
Labor Markets Set To Tighten Further In 2025 … From A 4.2% UR!

The largest influence behind the concept of economic utilization is, of course, employment. This should not be surprising since the U.S. is a mostly service-driven economy, where the best overall proxy of excess capacity is the utilization of people (i.e., unemployment rate). While the lagged effects of monetary policy are set to turn supportive for labor markets in 2025, we already see several leading indicators of employment flashing green, including some of the most reliable ones.

Hiring Intentions On The Rise …



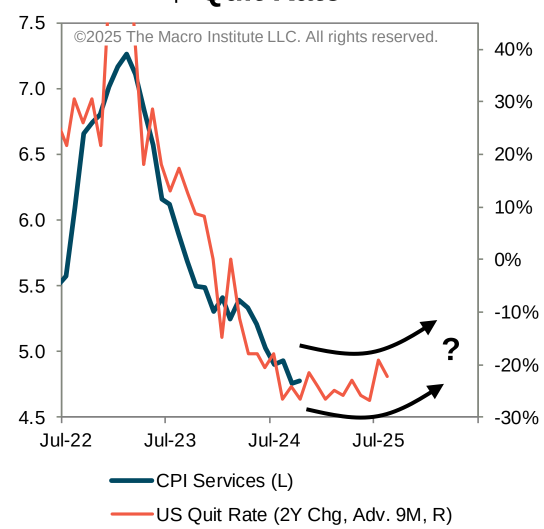
… And Sales Visibility Improving



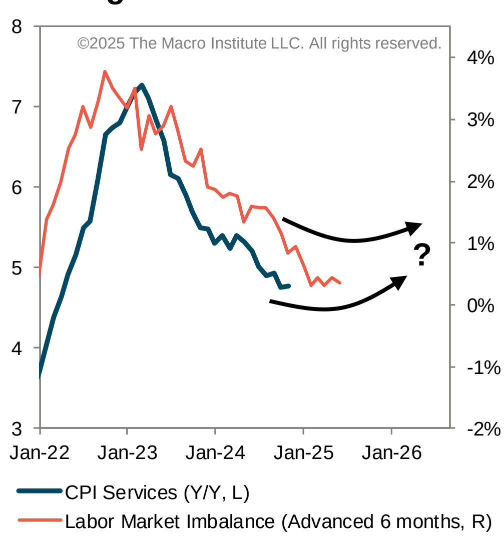
The NFIB data set has some of the best LEIs of employment. The charts above show hiring intentions of small companies improving recently and the number of companies reporting poor sales dwindling. These are both leading indicators of the unemployment rate, and they are now pointing toward it moving lower. The next logical step from tighter labor markets is an eventual pick up in wage inflation, which is tightly correlated with core inflation. It's not only the NFIB pointing to risks of higher inflation. Other proxies of labor market tightness like the Quit Rate and Conference Board data also argue for an inflection.

Several Different Sources Of Data ALL Pointing To Higher Inflation Ahead

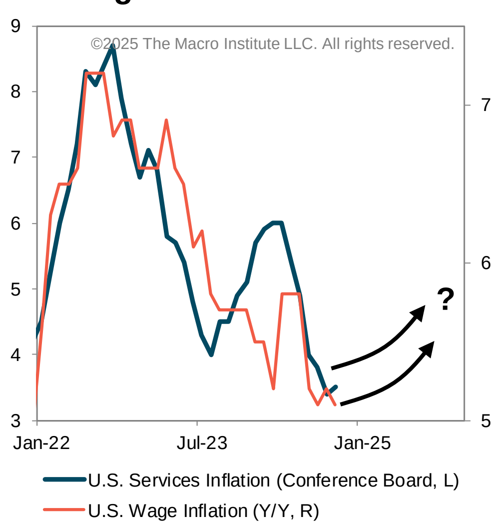
↑ Quit Rate



Tighter Labor Markets



Higher Inflation Ahead



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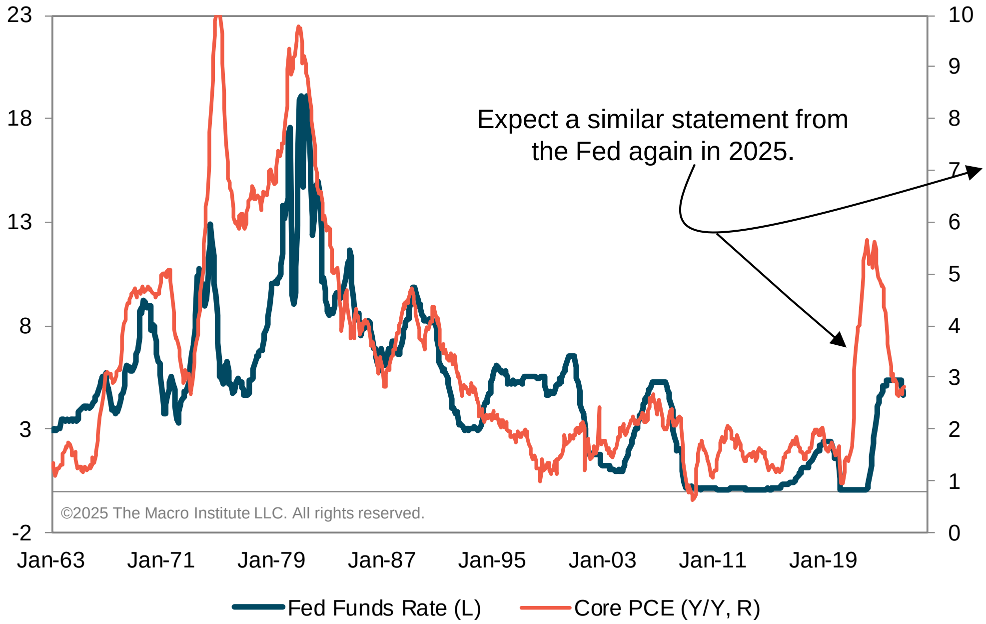
The Federal Reserve's Soft Landing Victory Lap Turns Sour In 2025

Let's focus on what the Fed WILL do here rather than what they SHOULD do. Let's face it, it will probably take some time for the Fed to acknowledge that inflation is no longer trending lower. They are, for the most part, taking a victory lap on their so-called soft landing now. A quick glance at the chart below shows that trends in core inflation do indeed play a large role in policy. There is precedent for the Fed easing policy too quickly BEFORE the battle against inflation was won. This occurred during the 1970s on Arthur F. Burns' watch and inflation rebounded in short order.

Higher Inflation = Fed Tightening Ahead

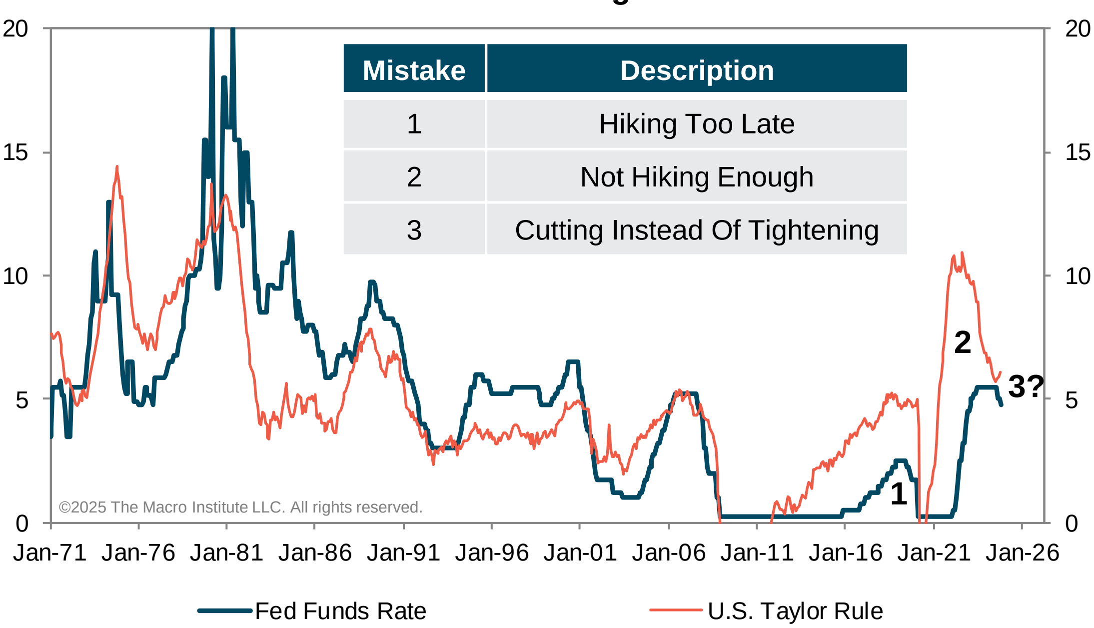


"Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation."

-FOMC Statement,
Dec. 15, 2021

The fact that the U.S. economy is still growing at a decent clip has caused many people to forget the Fed's disastrous performance in 2021. We saw a 40-year high in inflation before Chairman Powell even acknowledged it was a problem. The Fed then waited another three months to begin tightening policy! If inflation is going to recover from current levels in 2025, then the Fed will likely be left holding the bag (i.e., they will be blamed). History is unlikely to be kind to the Fed's current leadership.

Is Fed Chairman Powell Making His Third Mistake?



Mistake	Description
1	Hiking Too Late
2	Not Hiking Enough
3	Cutting Instead Of Tightening

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Policy Proposals COULD Dampen Or Accentuate Recovery In Inflation

A lot has been said about the policy proposals of the incoming administration. While they are for the most part unorthodox, they are still just proposals. We dedicated an entire conference call to this topic back in November, so we won't dwell on it too much here. Still, it's no secret that some of these policies could end up being inflationary. The business cycle will already prove inflationary, so the policy proposals are a bit of a side show. They could be serious, but inflation is likely moving higher regardless.

Trump Policy Proposals	Trump Plan (Billions)
Extend TCJA	-$5,350
Exempt Overtime Income From Tax	-$2,000
Exempt Social Security From Tax	-$1,300
Lower Corporate Tax Rate To 15%	-$200
Exempt Tips From Tax	-$300
Strengthen Military	-$400
Secure Border And **Deportations** #2	-$350
Housing Reforms	-$150
Boost Support For Health Care	-$150
#1 **Revenue** & **Spending Reductions** #3	+$3,700
Total Estimated Budget Impact	**-$6,500**

Source: Committee for a Responsible Federal Budget

Possible Fallout Of Policy Proposals?

Need revenue offsets for this priority.

#1 Tariffs

#2 Deportations

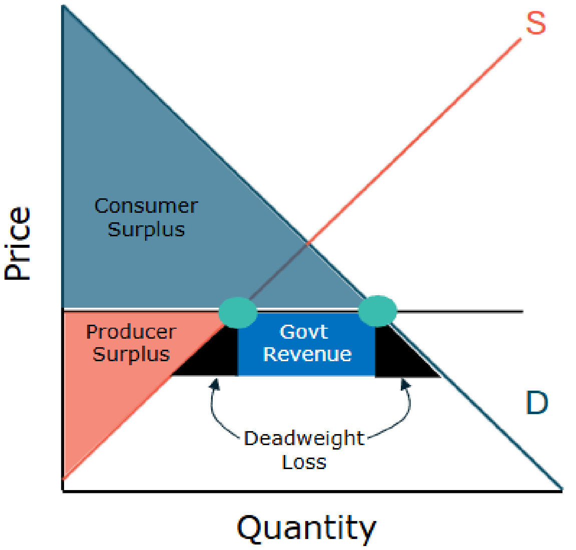
#3 Austerity

Tailwind for inflation?

Headwind for economy?

There are a lot of moving parts to the policy proposals, but at the heart of it all is the renewal of the 2017 tax cuts which are set to expire in 2025. Given the size of the federal deficit and the fiscal scoring for this extension, it is nearly impossible to extend the cut without finding additional sources of revenue. The reason tariffs come up a lot is because, from politicians' perspectives, they are an easy way to generate income for the government – if you ignore the consequences. We already know from the limited rounds of tariffs in 2018 that they were indeed inflationary. In other words, reality matched the theory.

2018 Experience Confirms Tariff Theory And Their Inflationary Consequences

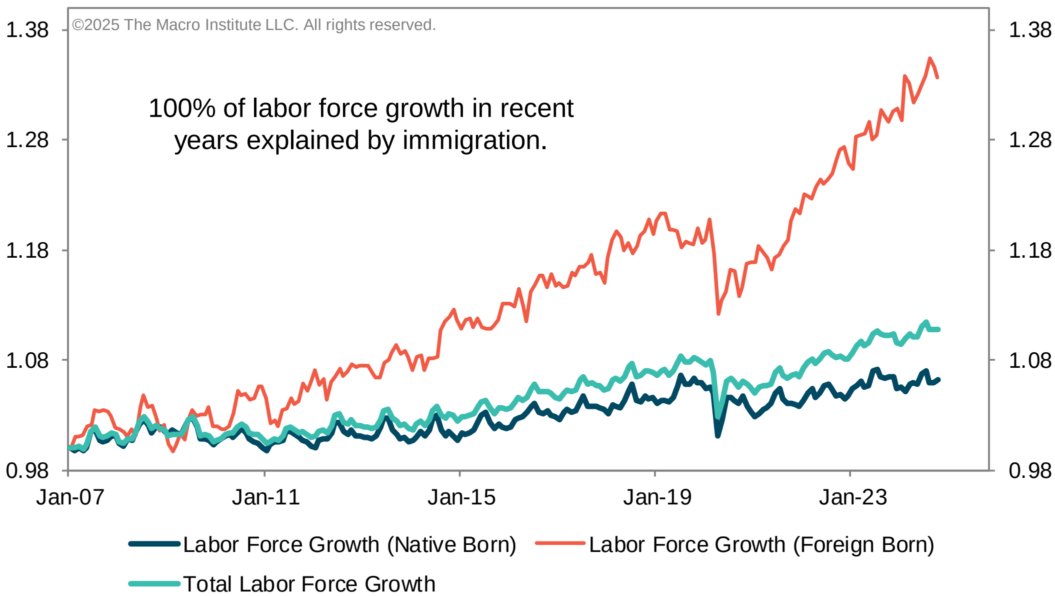


Source: Cavallo, Alberto, *Tariff Passthrough At The Border And At The Store: Evidence From US Trade Policy*, 2019.

Tariffs And Deportations Would Add Up To More Inflationary Pressures

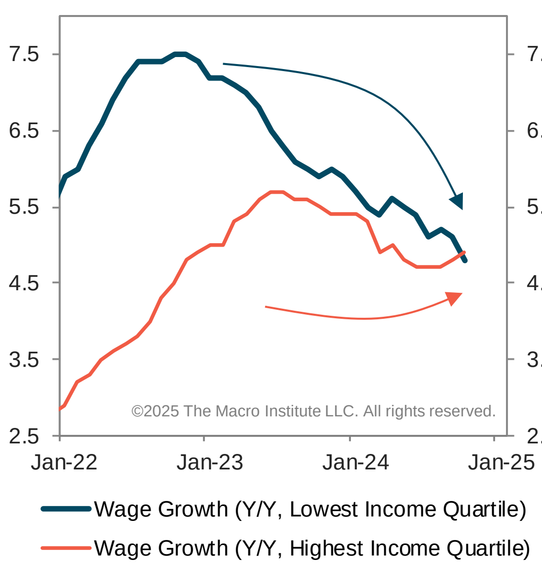
Let's start with a disclaimer: all the comments in this report are about policy and not politics. We only look at the economic consequences of potential policies and fully understand that there are other variables at play. From a mathematical standpoint, immigration has helped grow the U.S. labor force in the last 20 years. In the last five years, the native-born labor force has barely budged despite an increase in the participation rate. Worded differently, deportations could prove consequential.

U.S. Labor Force Growth Mostly About Foreign-Born Workers

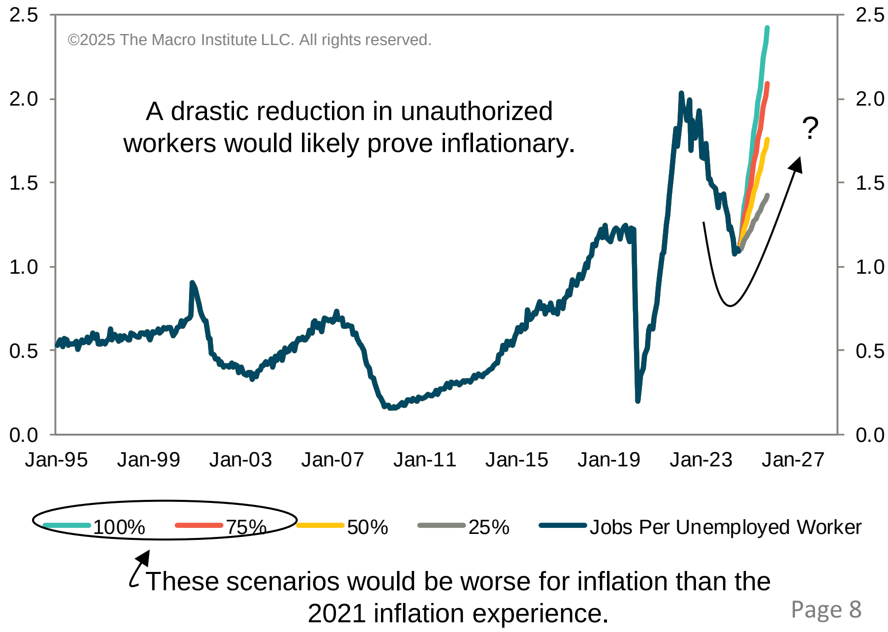


We don't know yet whether deportations will end up being a significant event. Truth be told, we are skeptical. What we do know, however, is that all the gains in the U.S. labor force in the last 6-7 years have come from foreign-born workers. Nevertheless, the NFIB survey shows that finding qualified workers is a great concern for small companies and most still report unfilled positions. Again, inflation will likely perk up this year even without tariffs and/or deportations. Those policies, if implemented in size, would likely accelerate the recovery in inflation. It's an incremental risk, but not the driving force.

Earlier/Faster Slowdown!



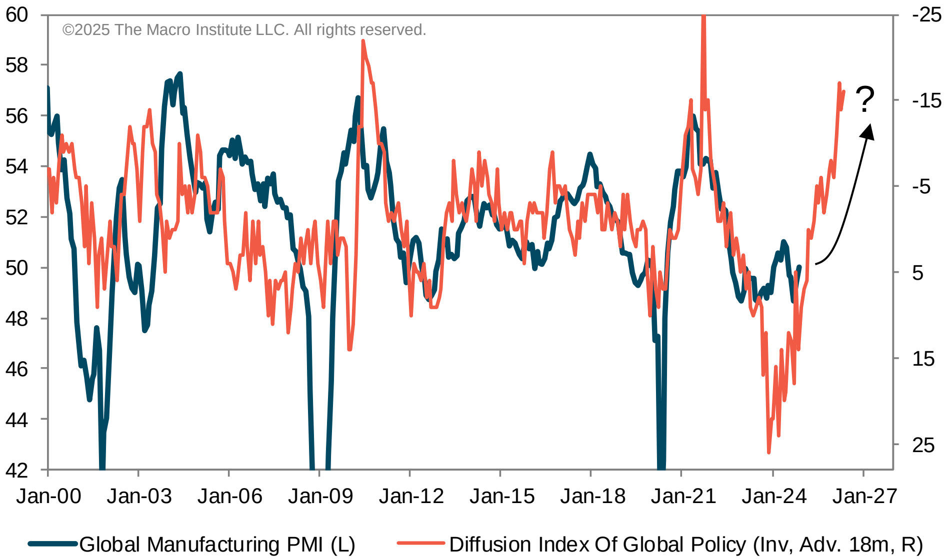
Labor Market Key Driver Of U.S. Inflation Trends



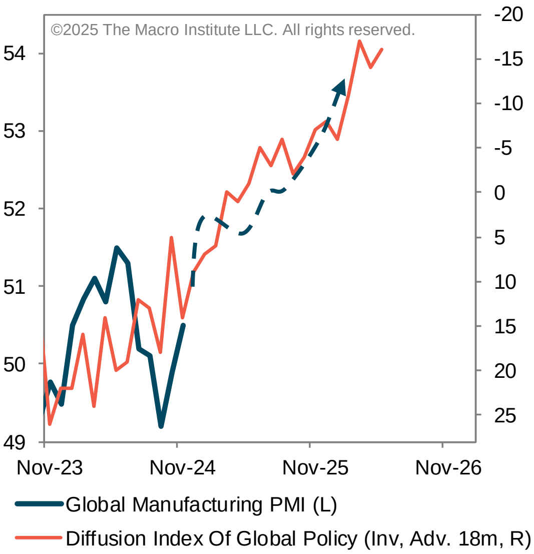
A Global Recovery Would Also Accentuate Inflationary Pressures.

We have written at length about how China's economic woes have benefitted U.S. equities in recent years by helping constrain inflation, and commodity prices more specifically. This has allowed P/Es – and especially growth stocks' P/Es – to expand massively. Looking at the rest of the world, there is stimulus in the pipeline, and the Global PMI, all other things equal, has likely seen its lows for the cycle. The unusually tight labor market in the U.S. and Fed rate cuts are the backbone of the inflation story, but political policies and a potential recovery abroad could add fuel to the fire.

Policy Has Sown The Seeds For A Global Recovery

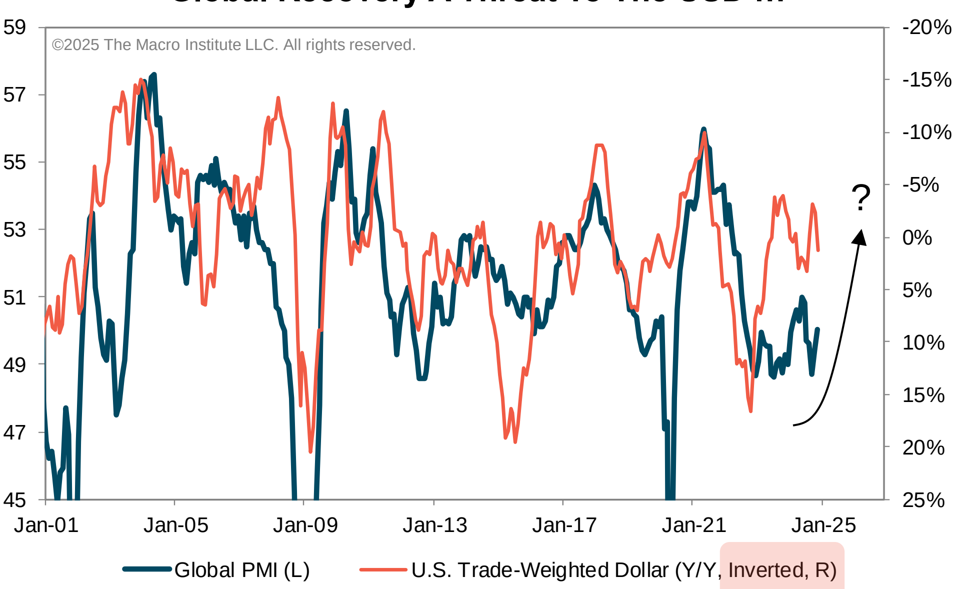


Recovery Through 2025

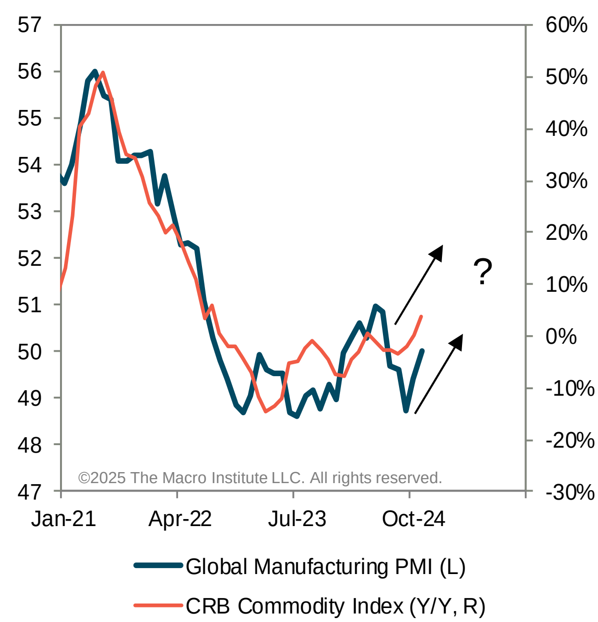


The rest of the world has been quick to ease policy, so there is plenty of stimulus in the pipeline as the clip above right illustrates. This is a simplified dynamic, but a recovery in the global backdrop is one where commodity prices typically recover which translates into higher inflation for most countries. Since a global recovery is usually also marked by a weaker U.S. dollar, the inflationary consequences are very real in America – especially at the gas pump! Barring an interruption in the global cycle from tariffs, expect the rest of the world to also contribute to the inflation story in 2025.

Global Recovery A Threat To The USD …



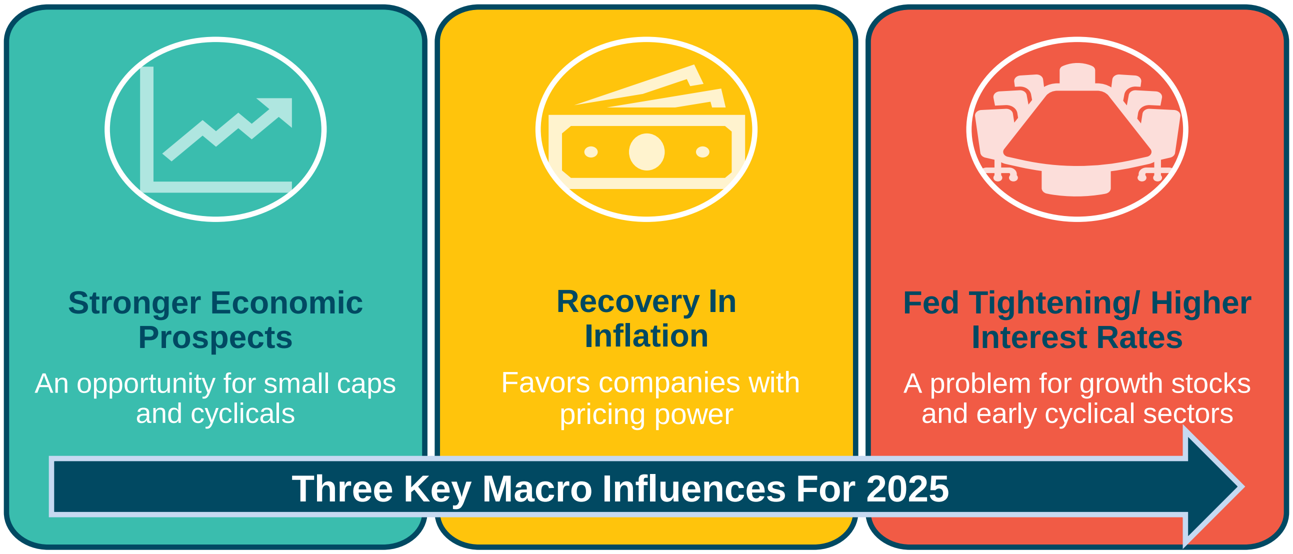
… Commodities Set To Recover?



Macro To Micro: Key Factors To Emphasize For An Unusual Backdrop

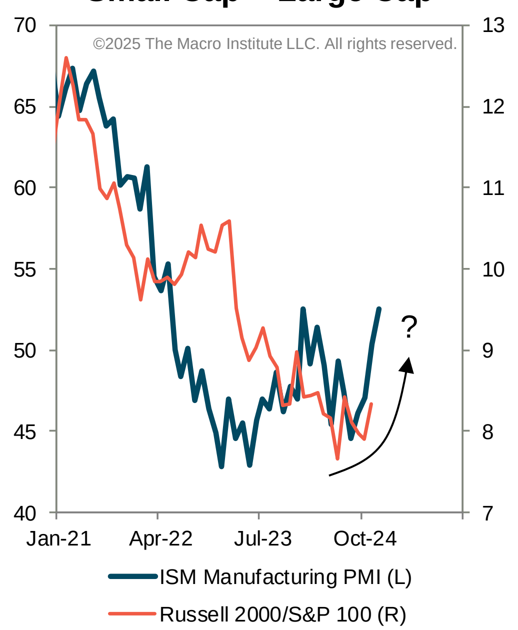
There are a few open questions about financial markets and we'll address these later. What is clear, however, is that when economic prospects improve, stock correlations move lower and create an easier backdrop for stock selection. There are three key macro themes that we believe investors should emphasize in their frameworks this year: 1) a rebound in economic prospects (i.e., LEIs), 2) a rebound in inflation (making pricing power key), and 3) a Fed that renews monetary tightening.

The Three Most Important Macro Trends In The Coming Year

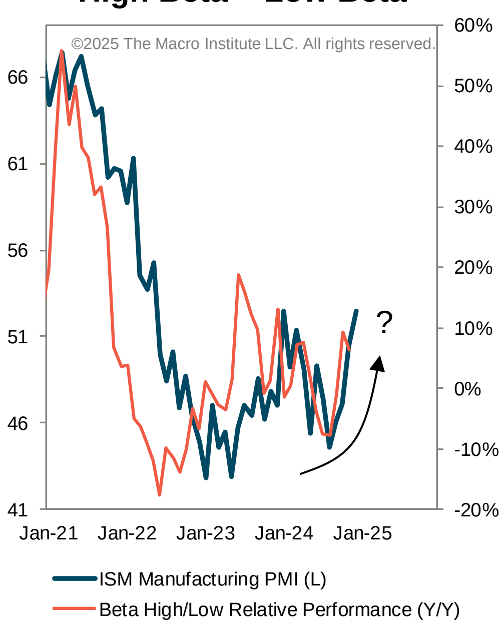


This is not exactly surprising, but a recovery in economic prospects typically favors small-caps, higher beta names, and cyclicality overall (see clip chart below right). One open question is whether there will be more alpha to gain in stocks with high foreign exposure. That is typically the case when we see a simultaneous recovery in economic prospects around the world, BUT tariffs could rapidly alter this dynamic. In our minds, emphasizing U.S.-centric cyclicals is one way to dampen this policy risk, but until policies change, we are somewhat agnostic about U.S.-centricity vs foreign exposure.

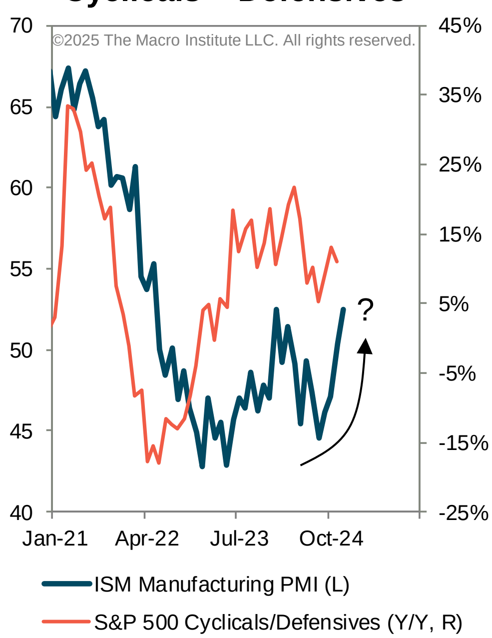
Small Cap > Large Cap



High Beta > Low Beta



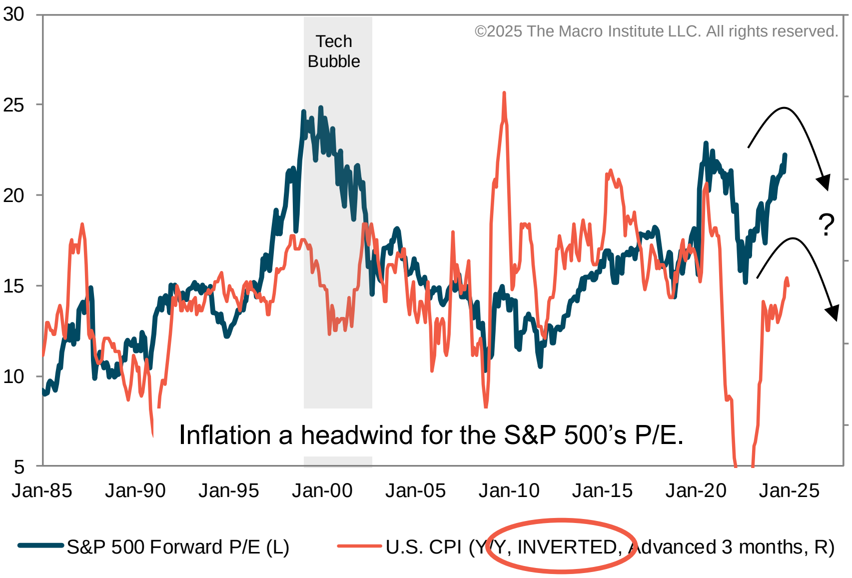
Cyclicals > Defensives



A Recovery In Inflation Means A Change In U.S. Equity Leadership

Inflation is probably the single greatest macro influence for stocks. A rebound in inflation has implications for the overall market, and growth-heavy indices in particular. It will also impact sector leadership – usually in favor of cyclicals that carry lower multiples overall – and stock selection, where pricing power usually becomes attractive in the eyes of investors. Few investors in the industry today have much experience with inflationary markets other than the 2021/22 period.

A Rebound In Inflation A Problem For Equity Multiples



Cyclicals Least Vulnerable?

Sector	Equity Duration
Energy	20.0
Financials	22.5
Materials	23.6
Comm. Services	24.3
Real Estate	24.4
Health Care	24.5
Industrials	24.5
Cons. Discretionary	24.8
Technology	25.4
Cons. Staples	26.2
Utilities	27.0

Outperforms in rising rate environment

Underperforms in rising rate environment

S&P 1500 12/2024

While it seems clear to us that all roads lead to higher inflation in 2025, the investment conclusions are not as clear. We feel confident that cyclicals will take over leadership from the Magnificent 7, so that part should change drastically. We also feel good about cyclical-heavy stock indices doing better than those with a large exposure to Growth (like the S&P 500 today). What the S&P 500 Index can deliver this year on an absolute basis is still a question. Will it look like a textbook cyclical rebound where the tide lifts all boats OR are we staring at something that looks like the early 2000s with a stealth bull market?!? More on that in Wednesday's conference call (register here).

Risk #1:

Cyclical Recovery Leads To A Pullback In Growth

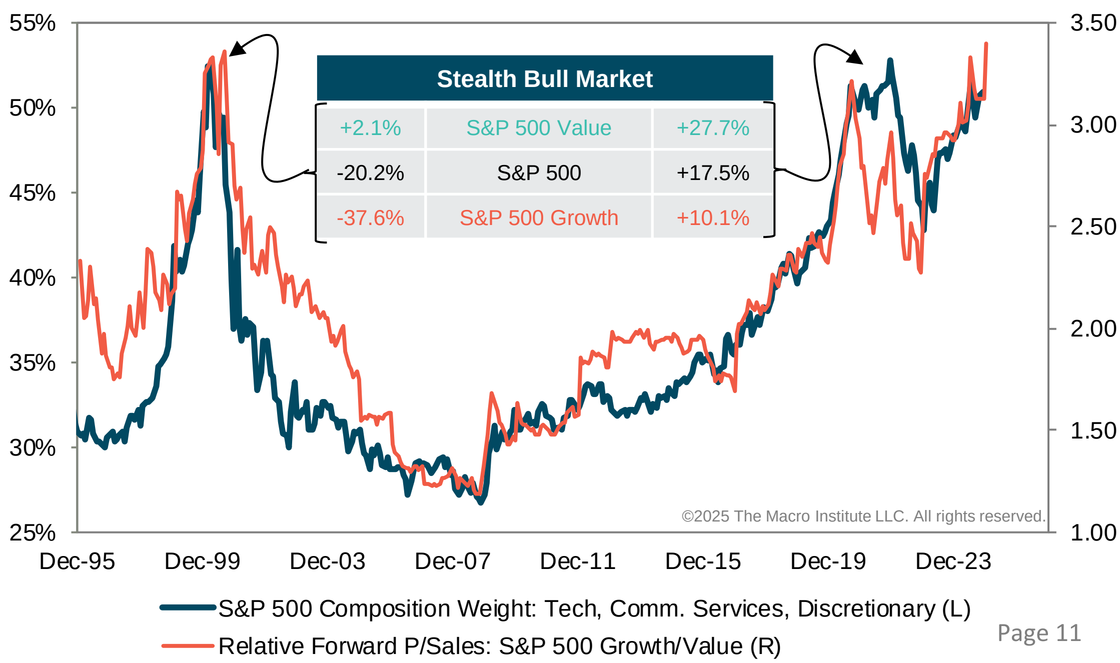
Risk #2:

Rising Interest Rates Weigh On Growth P/Es

Risk #3:

Crowding Often Triggers Panic Selling Across History

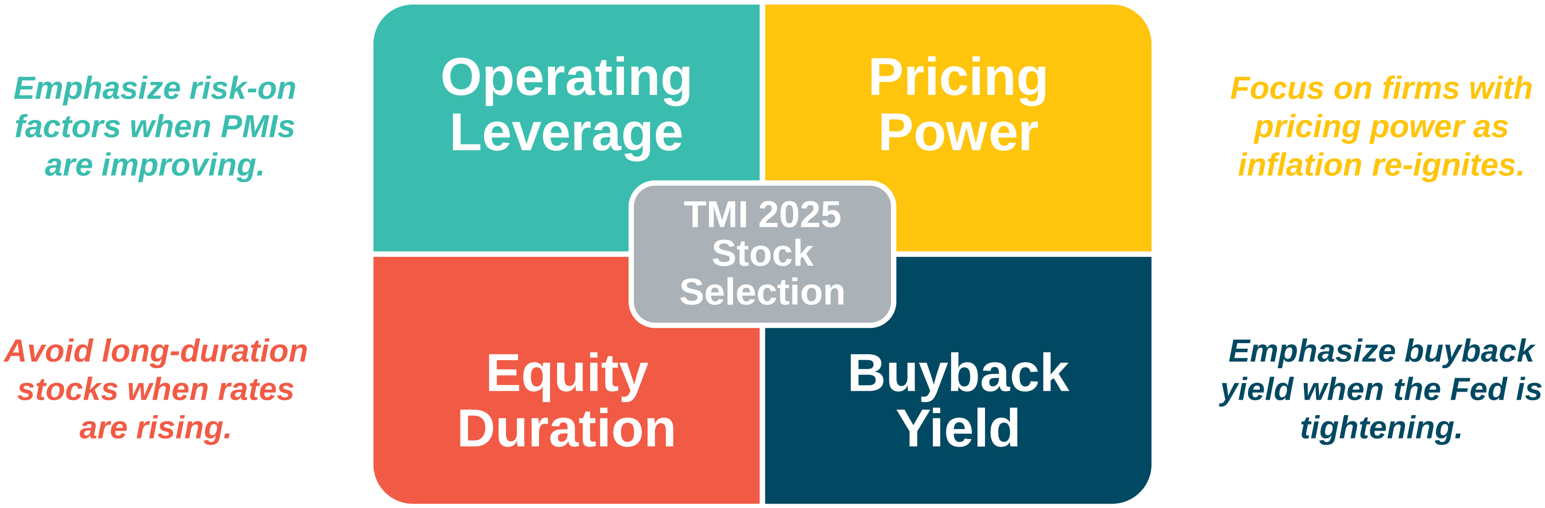
Valuation Disparity At Extremes … Stealth Bull Market In The Making?



A Good Starting Point For Stock Selection: 4 Key Factors For 2025

Let's recap – we like cyclicality, companies with strong pricing power, and ideally those with lower valuations. The first group benefits from improving LEIs, the second from a recovery in inflation, and the last one from the threat posed from higher bond yields. We would also add a fourth factor to the mix this year: buybacks. Buybacks is one of those rare factors that exhibits low correlations with the business cycle. That said, buybacks tend to add a lot of alpha during a Fed tightening cycle when dividends are often viewed as being at risk. This is the fourth factor we would look for stock selection in 2025.

The 2025 Stock Selection Playbook



The list below is just a cheat sheet of what the four-factor screen described above looks like. Again, we consider this a starting point, or a way to narrow the investable universe to the stocks most likely to be in sync with existing or emerging macro trends. Bottom-up analysis is still required of course, but this should save time when it comes to stock selection in 2025. Note that the full screen is available across most indices on our website or simply by emailing quant@themacroinstitute.com. We will adapt if/when conditions change (new policies!), but for now this is an excellent starting point in our minds.

A Sample Stock Listing Of The TMI 2025 Portfolio

THE MACRO INSTITUTE

Lower Deciles Rank Better In All Categories

Universe: S&P 500

TMI 2025 Outlook Portfolio

Ticker	Name	Equity Duration	Buyback Yield	Pricing Power	Operating Leverage	Price	Market Value	Sector	Industry
TSN	Tyson Foods, Inc. Class A	1	4	1	1	$ 57.83	20,192.6	Consumer Staples	Food Products
PSX	Phillips 66	1	1	2	1	$ 110.48	45,627.1	Energy	Oil Gas & Consumable Fuels
ARE	Alexandria Real Estate Equities, Inc.	1	4	2	1	$ 98.91	17,285.7	Real Estate	Health Care REITs
DHI	D.R. Horton, Inc.	1	2	3	1	$ 140.09	44,945.0	Consumer Discretionary	Household Durables
JNPR	Juniper Networks, Inc.	1	5	3	1	$ 37.48	12,409.2	Information Technology	Communications Equipment
PFE	Pfizer Inc.	1	5	3	1	$ 26.71	151,365.3	Health Care	Pharmaceuticals
EPAM	EPAM Systems, Inc.	1	1	4	1	$ 243.80	13,828.7	Information Technology	IT Services
FIS	Fidelity National Information Services, Ir	1	1	4	1	$ 81.40	43,822.0	Financials	Financial Services
HOLX	Hologic, Inc.	1	1	4	1	$ 72.50	16,453.2	Health Care	Health Care Equipment & Supplies
PYPL	PayPal Holdings, Inc.	1	1	4	1	$ 86.90	87,120.6	Financials	Financial Services
BRK.B	Berkshire Hathaway Inc. Class B	1	4	4	1	$ 454.35	980,027.4	Financials	Financial Services
LYB	LyondellBasell Industries N[illegible]	1	4	[illegible]	1	$ [illegible]	[illegible]	Materials	Chemicals
CTRA	Coterra Energy Inc.	[illegible]	[illegible]	[illegible]	1	$ [illegible]	[illegible]	Energy	Oil Gas & Consumable Fuels
RVTY	Revvity, Inc.	1	3	5	1	$ 112.27	13,663.5	Health Care	Life Sciences Tools & Services
TROW	T. Rowe Price Group	1	3	5	[illegible]	$ [illegible]	25,786.0	Financials	Capital Markets

2024's Unique Features Set To Have An Economic/Markets Impact In 2025

Join us for our 2025 Outlook Call, where we'll discuss the sectors and factors we believe are best positioned for success in the coming year. We will also explore the potential for inflation to reemerge as a key theme and its implications for markets. Please join us on Wednesday, January 8th at 10:30 am EST. Click the link below to register and receive your unique dial-in information.

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The Great Inflation Comeback Of 2025

Host: Francois Trahan

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