REGIONS ASSET MANAGEMENT

Investment Strategy Outlook

DECEMBER 2024

THE ECONOMY

Policy Contours Forming, Details Have Yet To Take Shape

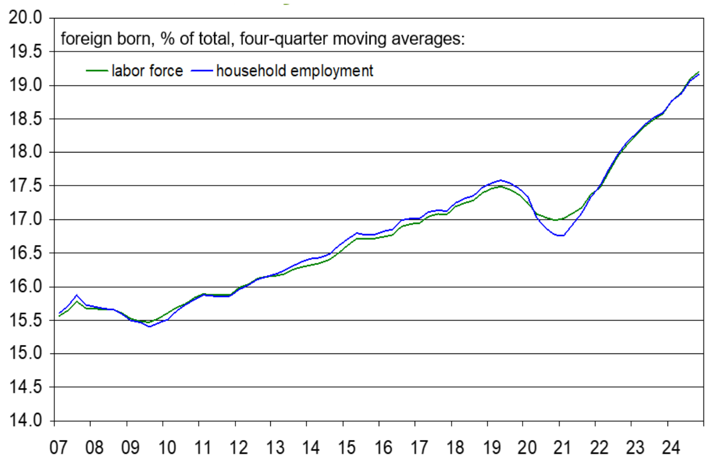
That the Presidential and Congressional elections are behind us does not mean that the uncertainty around those elections is behind us. Though the broad contours have started to form, the specific details on what could be potentially significant changes to fiscal, trade, regulatory, and immigration policy have yet to be revealed. The lack of specific details makes forecasting the path of the U.S. economy over coming quarters an even trickier endeavor than is typically the case, which is a point that we will no doubt make early, and often, next month in our annual outlook edition. Two policy areas in which the incoming Trump Administration seems likely to seek potentially sweeping changes are immigration and trade. Though there are not yet any specific details to go on, we think it worth offering some general points to keep in mind as you process potential impacts of changes to immigration and trade policy.

For instance, we've heard some argue that reduced immigration flows will lead to lower rates of inflation, the premise being that less demand for goods and services will put downward pressure on prices. The problem with arguments based solely on demand, however, is that they are, well, based solely on demand while ignoring the supply side of the economy and, as we understand these things, less demand does not mean more supply. Rapid growth in the supply of foreign born labor has been a primary driver of faster growth in total labor supply over recent years. As such, to the extent immigration reform acts as a brake on the pace of growth in labor supply and, in turn, employment, it could be that the corresponding hit to supply results in greater upward pressure on prices that would offset any downward pressure stemming from there being less demand. This is a point apparently lost on those who argue immigration reform will curb the pace of house price appreciation, given the extent to which foreign born labor is a key source of construction labor.

The reality is that long-running demographic trends have resulted in slowing growth in native born labor supply, a trait by no means limited to the U.S., meaning that foreign born labor has become an increasingly important driver of growth in the supply of labor. This, in turn, has facilitated faster growth in the supply of goods and services than would have otherwise been the case. The household survey data presented in the monthly employment reports clearly show the impact of foreign born labor. Amongst the various demographic cuts of the household survey data is that between native born and foreign born labor market participants. Note that survey respondents are not asked about their immigration status but, either way, foreign born participants have accounted for rapidly rising shares of the labor force and household employment over recent years; as of November, foreign born participants accounted for 19.2 percent of the U.S. labor force and 19.1 percent of household employment.

This helps illustrate a point we've made over the past several months, which is that upward pressure on the unemployment rate has been much more a function of faster growth in the labor force than of greater numbers of people losing their jobs. We have, however, noted that we did not think the rapid rate of growth in foreign born participants seen over the past few years would be sustained indefinitely. The corresponding slowdown in labor force growth would, in turn, cap any increase in the unemployment rate stemming from a slower pace of job growth. Immigration reform, regardless of the specific form it takes, would buttress our argument. At the same time, however, less foreign born labor would mean slower growth in the labor force, potentially putting renewed upward pressure on wages while at the same time curbing growth in the production of goods/provision of services, resulting in renewed upward pressure on prices. The point here is not to argue that there is no need for immigration reform. Instead, our point is that along with immigration reform could come potentially significant disruptions in labor supply and, in turn, the broader economy. Any such reform will hopefully be crafted with the points we've made here in mind, and these points will guide our assessment of the specific policy details that emerge.

Foreign Born Shares Ahead Of Pre-Pandemic Trends



Source: Bureau of Labor Statistics; Regions Economics Division

Along the same lines, we think there are some general points to keep in mind as the specific details on trade policy emerge over coming months, specifically, whether or to what extent tariffs will be expanded. One question to consider is what the point of expanded tariffs would be, as expanded tariffs could be intended as: 1) a means of raising revenue to help offset higher spending and/or the costs of extending the 2017 tax cuts or implementing any additional tax cuts; 2) a means of addressing trade practices or other policies perceived to be at odds with U.S. interests; 3) a means of protecting domestic producers from foreign competition deemed to be unfair; or 4) a means of directing manufacturing activity to the U.S.

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While a specific tariff on a single foreign nation can be some of those things, it cannot be all of those things, which suggests that we are unlikely to see "blanket" tariffs at a specific rate aimed at every foreign trading partner. In the second case above, it could be that the threat of expanded tariffs is sufficient to bring other nations to the negotiating table – that tariffs were deployed in the first Trump Administration should remove any doubt as to whether the threat of expanded tariffs is indeed a credible threat.

In terms of the potential revenue brought by expanded tariffs, it helps to note that, of the roughly $3.1 trillion of goods imported into the U.S. in 2023, forty-three percent came from just three nations – Canada, China, and Mexico. To put that in perspective, you'd have to add up the shares of the next nineteen countries on that list arrive at a combined share of forty-three percent. Note that the share of imports coming from China began to erode rapidly in the wake of tariffs put into place during the first Trump Administration. This in part reflects firms who had been importing goods from China diversifying supply chains and in part reflects Chinese firms shifting production and/or assembly of goods to other Asian nations.

We'd expect to see the same reactions in response to expanded tariffs on Chinese-made goods, particularly if tariffs were raised as high as has sometimes been suggested. Think about this in the context of the intent of the tariffs, however, and it points to the difficulty in using tariffs to achieve specific objectives, such as a source of government revenue. This suggests significantly higher tariffs on Chinese goods would be unlikely to raise targeted amounts of revenue, and that tariffs would have to be imposed on a much wider group of countries, and tariff rates would have to be higher, to achieve the same revenue objectives.

That U.S. exports are similarly concentrated amongst the same group of countries could be seen as suggesting the U.S. has little to fear from other nations imposing retaliatory tariffs on U.S.-made goods. Of the roughly $2.0 trillion of exports of U.S. goods in 2023, forty-one percent went to either Canada, China, or Mexico – you'd have to add up the shares of the next eighteen countries on that list to get to a similar combined share. That said, if, Canada and Mexico were to be subject to significantly higher tariffs on imports into the U.S., as has been suggested, that could easily result in more U.S. firms feeling significantly more pain from Canada and Mexico imposing retaliatory tariffs.

These are just a few illustrations of our broader point, which is that even once details of changes to trade policy come to light, the implications of these changes will be anything but straightforward and are likely to take time to fully play out. This adjustment process will likely be something that sends forecasters back to the drawing board given the number of possible permutations, in both policy changes and the reactions to those changes, that can impact the paths of output, employment, inflation, and interest rates.

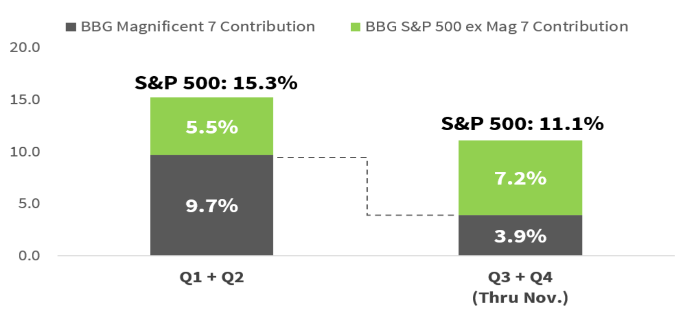
Sources: Bureau of Labor Statistics; U.S. Census Bureau; International Trade Administration

STOCKS

Santa Likely To Lift Stocks In December, But The Calendar, Sentiment Pose Risks Early Next Year

If history is any guide, U.S. large-cap stocks should have the wind at their sails into year-end as the S&P 500 attempts to close out 2024 with a greater than 30% total return. Liquidity remains ample and supportive of further gains, evidenced by a continued lift in prices of riskier asset classes of late. Shorter-term measures of S&P 500 participation have deteriorated in December but around two-thirds of S&P 500 constituents still traded above their respective 200-day moving average as of mid-month. We would characterize breadth readings on the S&P 500 as falling somewhere between good enough and solid at present, but we will be watching for further signs that leadership is faltering and narrowing, potentially a sign that a pullback of some magnitude is in the works. With this backdrop in place, market participants have few reasons to fight the prevailing uptrend in U.S. large-cap stocks into January, and with tax rates on capital gains unlikely to rise in 2025 investors could push sales into the next tax year, lessening one headwind for stock prices that comes into play at year-end.

1st & 2nd Half Splits Highlight S&P Leadership Broadening



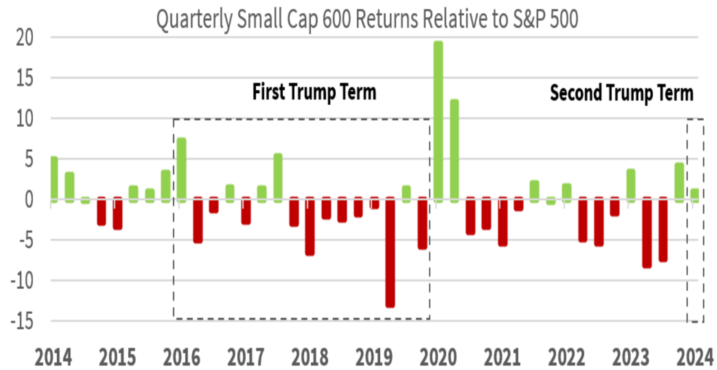
With that said, the positive seasonal backdrop currently in place for stocks often shifts in late-January. The S&P 500 has historically faced tough sledding in the month of February, generating a -0.09% average return during the month dating back to 1928, making it one of only three calendar months to generate, on average, a negative return. Bullish sentiment approaching the highest level seen this year is another risk worth watching as a contrarian indicator. Sentiment surveys are far from a perfect guidepost when it comes to accurately signaling market tops or reversals, particularly during the month of December, and after strong year-to-date gains, holiday cheer can boost sentiment, risk appetite, and stock prices to unexpected levels, but sentiment could shift early in the new year as investors rebalance portfolios.

Year-To-Date Winners Have Historically Been Left Out Of Year-End Rallies As Investors Chase Beta. December has historically been a positive month for equity market, but factor exposures haven't all fared so well during the month, with momentum and quality generating negative returns, on average, during the month over the past decade. That fact flies in the face of the conventional wisdom that year-to-date winners keep on winning and carry the leadership baton through year-end, but it has been more volatile, higher beta stocks that have fared best in December in recent years. Up to this point in the month, we're seeing this dynamic play out yet again as the iShares Momentum ETF (MTUM) has declined by 1.6% while Invesco's S&P 500 High Beta factor ETF (SPHB) has rallied by 1.8%. Momentum-based strategies tend to be populated with stocks in a longer-term uptrend, often over the previous 6- or 12-months, while beta products attempt to allocate to the stocks with the greatest sensitivity to market movements, both to the upside and downside. Portfolio managers window dressing and stretching for alpha at the last minute is one possible driver of a year-end beta rally. While we wouldn't be surprised if more volatile names of questionable quality lead in the coming weeks, chasing those names could prove to be costly if market sentiment shifts.

Will Trump 2.0 Mean More Of The Same (Underperformance) For SMid? Investors dusted off their 2016 playbook in the wake of the November elections, reigniting interest in smaller companies and propelling the S&P Small Cap 600 to a 10.9% gain in November alone, nearly doubling the S&P 500's monthly return. The small cap advance rhymed with what occurred in November of 2016, when the small cap index surged by 12.5%, but companies farther down the market cap spectrum had also led for most of that year up to that point and were in a different fundamental position than they appear to be in today. The potential for a more volatile global trade backdrop in the coming years alone begs the question, is the rotation into SMid for real, or set to fade as it did during President Trump's first term?

It's no secret that small- and mid-cap companies rely less heavily on foreign sales to drive profits, and in an environment where U.S. tariffs on imported goods could rise, and with our trade partners potentially responding with tit-for-tat tariffs on U.S. imports, smaller companies should be relative beneficiaries. However, that wasn't the case in 2017, the year tariffs were implemented in President Trump's first term, as the S&P 500 outpaced the S&P Small Cap 600 by 8.6% as, despite the political sparring, the ultimate outcome posed less of a headwind for financial markets and multinational based in the U.S. than feared. SMid cap stocks carry attractive valuations relative to their expected earnings growth in the coming year and should provide some insulation in a tail-risk trade scenario if trade/tariff rhetoric ramps up, but macro tailwinds may not be enough to win over investors and turn them into believers. We are optimistic that an uptick in mergers and acquisitions (M&A) and deregulation will boost SMid in '25, but they will also provide tailwinds for companies in the S&P 500 as well. We recommend allocations to both U.S. large-caps and U.S. SMid that fall in-line with our strategic allocations as a result.

The "Trump Bump" Failed To Buoy SMID For Long Last Time



Shorter-Term Breadth Measures Improving Abroad. Supportive Of A Lift Into Year-End For Developed Markets Abroad. Measures of participation or market breadth stateside have allowed us to remain constructive on U.S. stocks over the balance of 2024. But those same measures or metrics have been more mixed for developed and developing markets abroad, which has led us, and many other investors, to the conclusion that the U.S. remained the place to be for investors looking to take equity risk. However, breadth measures have noticeably improved abroad thus far in December with over three-quarters of the constituents of the Euro Stoxx 50, CAC 40 in France, German DAX, Hong Kong Hang Seng, and China's Shanghai Composite trading above their 10-day moving average. While this is admittedly just a measure of shorter-term momentum and could quickly fizzle out, it is encouraging that capital is finding its way into these markets despite political dysfunction (France, Germany) and lackluster economic growth (China, Euro Area) garnering headlines.

Weakness in the U.S. dollar of late has spurred greater interest in foreign markets and there is quite a bit of negative news already priced in, particularly for developed markets abroad, evidenced by the MSCI EAFE trading at 14 times trailing 12-months earnings, well below the 30-year average of 20 times. Clarity on the trade/tariff front and some signs of stability in the U.S. dollar could drive improved sentiment surrounding international markets in the coming year, and it might not take much in the way of positive news to do so amid low valuations and paltry expectations for economic growth and earnings abroad. With that said, outlining a path higher for U.S. stocks is a far easier exercise and we expect the S&P 500 to outpace foreign developed markets in the coming year as capital continues to flow into U.S. assets.

BONDS

Cabinet Appointments Spur Treasury Rally, But Tariff Talk Could Put A Floor Under Yields

Calm returned to the bond market in the back-half of November as President-elect Trump announced that he would tap hedge fund manager Scott Bessent to be Treasury Secretary, a move cheered by fixed income investors that led to a rally in long-dated U.S. Treasuries and forced yields lower. Market participants view Bessent as a student of history and rational thinker equipped with the 'right stuff' to guide the U.S. government through the challenge of making interest payments on some $35T of debt, all while the budget deficit continues to grow with little near-term spending relief on the way. Tough decisions must be made in the coming year(s), and after focusing issuance on the short-end of the Treasury curve via bills in recent years, the U.S. government needs to term-out borrowing by issuing more long-term notes and bonds. To make this pivot without rattling markets and forcing Treasury yields higher, insurance companies, pension plans, and sovereign wealth funds must buy into the idea that the U.S. government is capable of making strides toward getting its fiscal house in order, and Bessent's nomination has, at least initially, been viewed as doing just that.

While market participants received clarity on who would lead the U.S. Treasury, certainty on the tariff front may remain elusive for a while longer, putting a floor under long-term Treasury yields. Tariffs on Chinese exports are expected to rise but could end up below the 60% rate bandied about when the President-elect was on the campaign trail, and with recent cabinet appointments taking on a less protectionist or nationalistic tone, "blanket" tariffs on all imports appear less likely. Ultimately, cooler heads should prevail, but tariff rhetoric will be used as a negotiating tactic for some time to come and interest rates will likely remain volatile as a result. A more targeted approach to tariffs would ease fears that inflation could spike and in turn lowers the likelihood that the 10-year Treasury yield is on a collision course with the 5% level, or above, over the near-term. However, we see little downside for yields on long-term Treasuries as investors require greater compensation for taking on interest rate risk amid this highly volatile and uncertain backdrop. As a result, we view core investment-grade bonds, specifically Treasuries, as a 'clip your coupon,' at best, asset class over the balance of 2025. U.S. corporate high yield, floating rate bonds, asset-backed securities, and developed market sovereigns abroad all hold appeal for diversification purposes and help lower the volatility profile of fixed income portfolios.

Credit Markets May Have A Little Too Much Cheer Heading Into The New Year. Valuations in below investment grade credit capped off their 4th consecutive month of spread tightening in November, a streak last seen in the second half of 2020. The recent run of spread tightening for high yield bonds has started to dampen the relative appeal of corporate credit. The Bloomberg High Yield Index has returned a hefty 8.7% with just one month to go in 2024, topping the index's 7.6% yield-to-worst at the start of the year as the combination of credit spread compression and rate movement have driven prices ever higher. Price appreciation in high yield land shouldn't be taken for granted as it has now only occurred in five of the last ten years with the only other repeat occurrence before the last two years happening in 2016 and 2017.

Those historical statistics alone aren't enough to drive us out of below investment grade securities, as market 'firsts' happen often, but when viewed in concert with ultra-tight corporate credit spreads, the data warrant a deeper dive to ensure one is not taking unnecessary risk in what could be a more volatile market going forward. Valuations are just one factor in forecasting market returns in our approach, but with spreads just 30-basis points above the all-time tight level reached in 2007, investors will likely benefit from taking a more guarded approach to below investment-grade corporate bonds in the coming year. Given our current position in the economic and credit cycle, we see few catalysts for a sizable sell-off in high yield corporates but hold the view that investors should be tempering their expectations for this segment after back-to-back years of above average returns.

If History Holds, Tougher Times May Lie Ahead For High Yield