TRADITION
INVESTMENT MANAGEMENT

Economic and Market Review December 2024

January 1, 2025

Equity Indices	YTD Return
Dow Jones	12.40%
S&P500	23.74%
NASDAQ	30.58%
MSCI - Europe	4.97%
MSCI–Emerging	7.65%
Bonds (Yield)	
2yr Treasury	4.25%
10yr Treasury	4.56%
10yr Municipal	3.11%
U.S. Corporate	5.33%
Commodities	
Gold	$2,658.53/oz
Silver	$29.53/oz
Crude Oil (WTI)	$73.14/bbl
Natural Gas	$3.67/MMBtu
Currencies	
CAD/USD	$0.69
GBP/USD	$1.24
USD/JPY	¥147.29
EUR/USD	$1.03

Overview

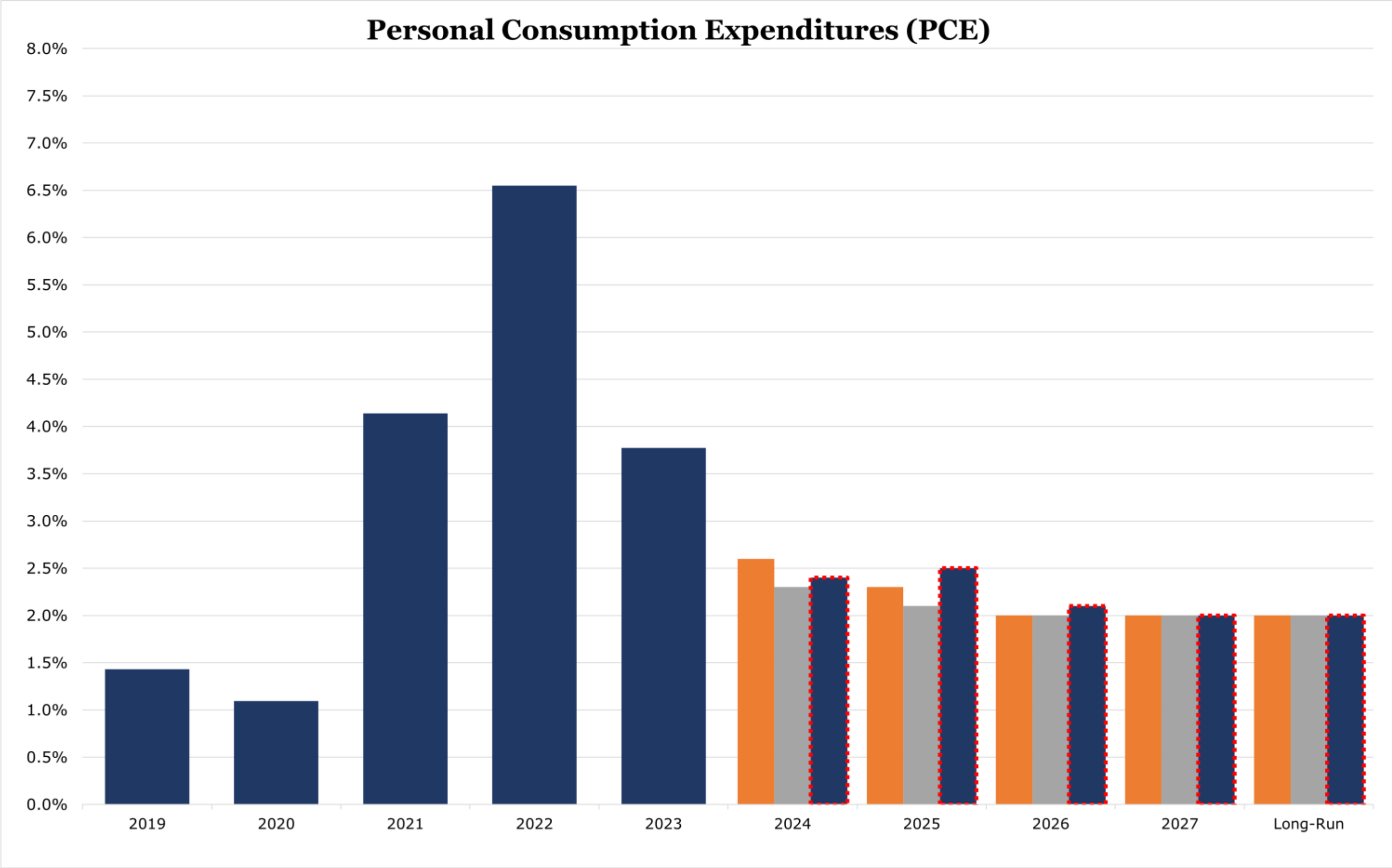
Despite a "Santa Claus Rally" not materializing, the S&P500 ended the trading year up 23%, after rising 24% in 2023. This back-to-back performance is the best since 1997 and 1998.

The US dollar continues to see strong gains, rising to its highest level since 2022, driven by optimism in the US economy. While a Trump victory had taken some momentum away from gold's historic rally, the Fed's economic projections now officially expect higher-for-longer inflation, which restarted gold's upward move, ending 2024 with a gain of 27%.

As a result of the higher-for-longer inflation expectations, the US 30-year fixed mortgage rate ended 2024 at 7.0%, the highest level in 6 months despite the Fed cutting rates 3 times during 2024. Mortgage rates are now at their highest level since 2021, though this has not impacted home values with the median house cost increasing to $406,100 during December, a 48.2% increase compared to before the pandemic.

Trump's election has similarly taken the wind out of the 15% rally Chinese equities following historic government stimulus. Many industries, such as oil and mining, continue to await a Chinese economic recovery. However, output data still came in below estimates in December, stoking fears that the Chinese economy may never fully reach pre-pandemic levels on top of tariff fears. The CSI 300 index fell 2.9% in the worst-first day for a trading year since 2016.

Fed Cuts Despite Increased Inflation Expectation and Reduced GDP Expectation

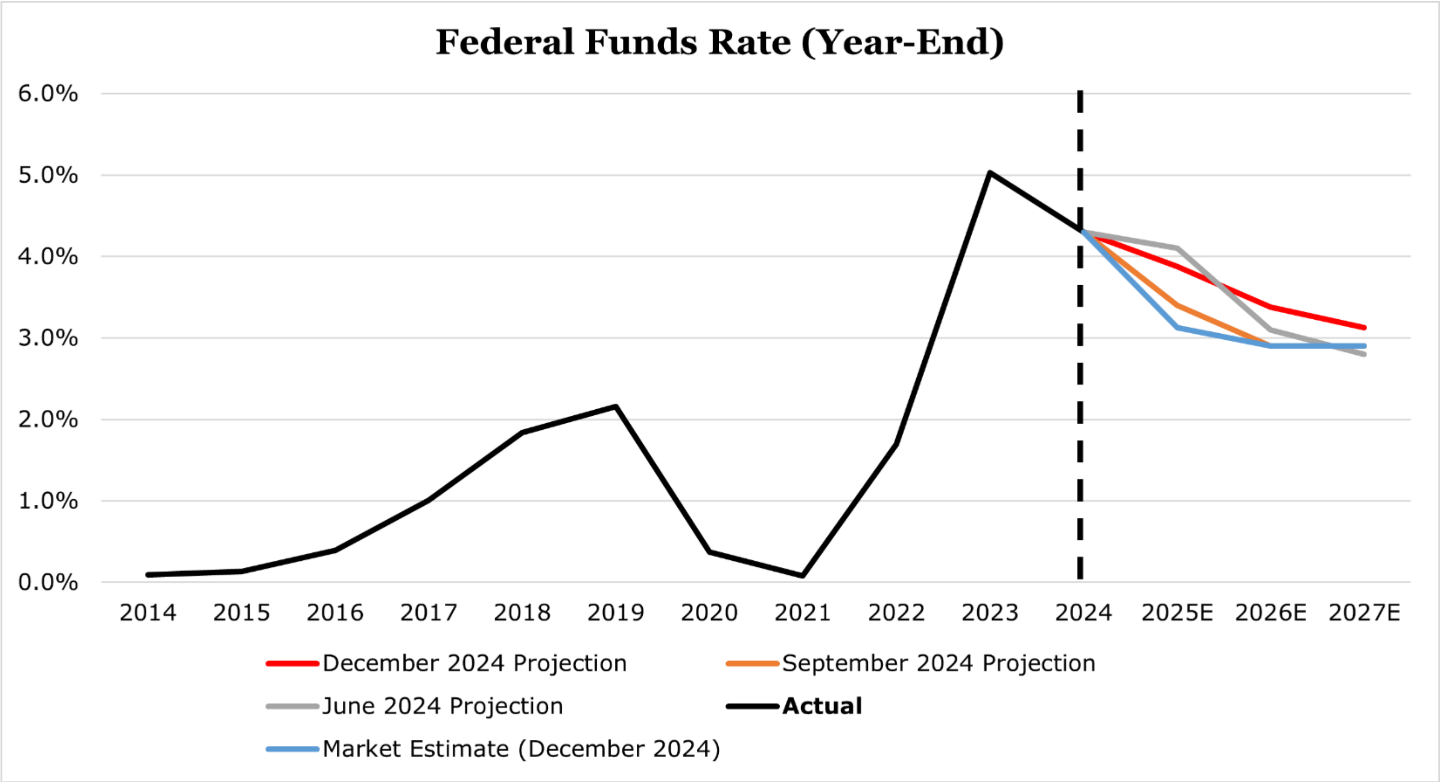


PCE	2024	2025	2026	2027	Long-Run
December 2024 Projection	**2.4%**	**2.5%**	**2.1%**	2.0%	2.0%
September 2024 Projection	2.3%	2.1%	2.0%	2.0%	2.0%
June 2024 Projection	2.6%	2.3%	2.0%	2.0%	2.0%

PCE (personal consumption expenditures) is the measure of inflation more commonly used by the Federal Reserve when implementing short-run monetary policy. The primary difference between PCE and CPI (consumer price index) is that PCE's weights are updated monthly, rather than yearly. Data from the FOMC (Federal Open Market Committee).

With its final meeting of the year in early December, the Fed released its last forward estimate for 2024. Despite being cut by a further 25bps, the year-end inflation estimate for 2024, 2025, and 2026 have been revised upward.

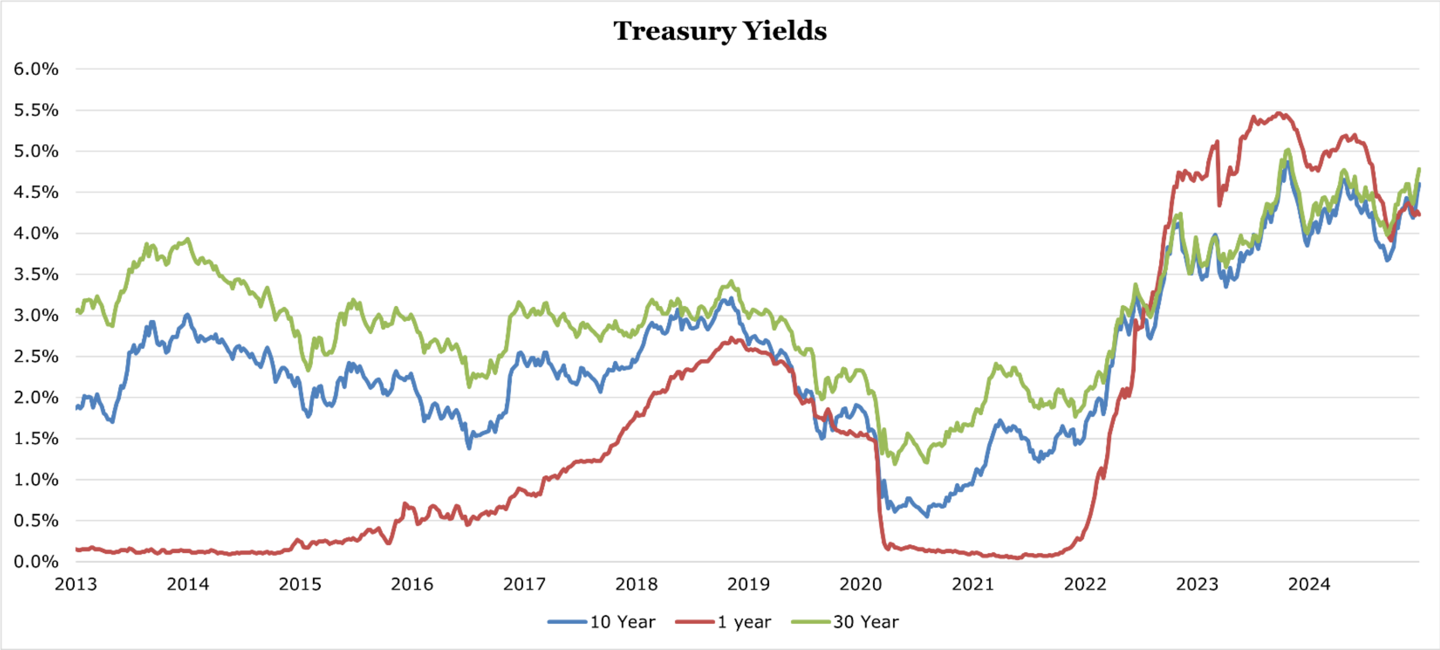
The Fed's own Federal Funds Rate prediction has moved back up, and thus a pessimism about the breadth of future cuts has begun to enter the market. The newest projections from the FOMC (Federal Open Market Committee) expect a higher terminal rate to be reached over a longer-period of time, implying less than 3 cuts in 2025.



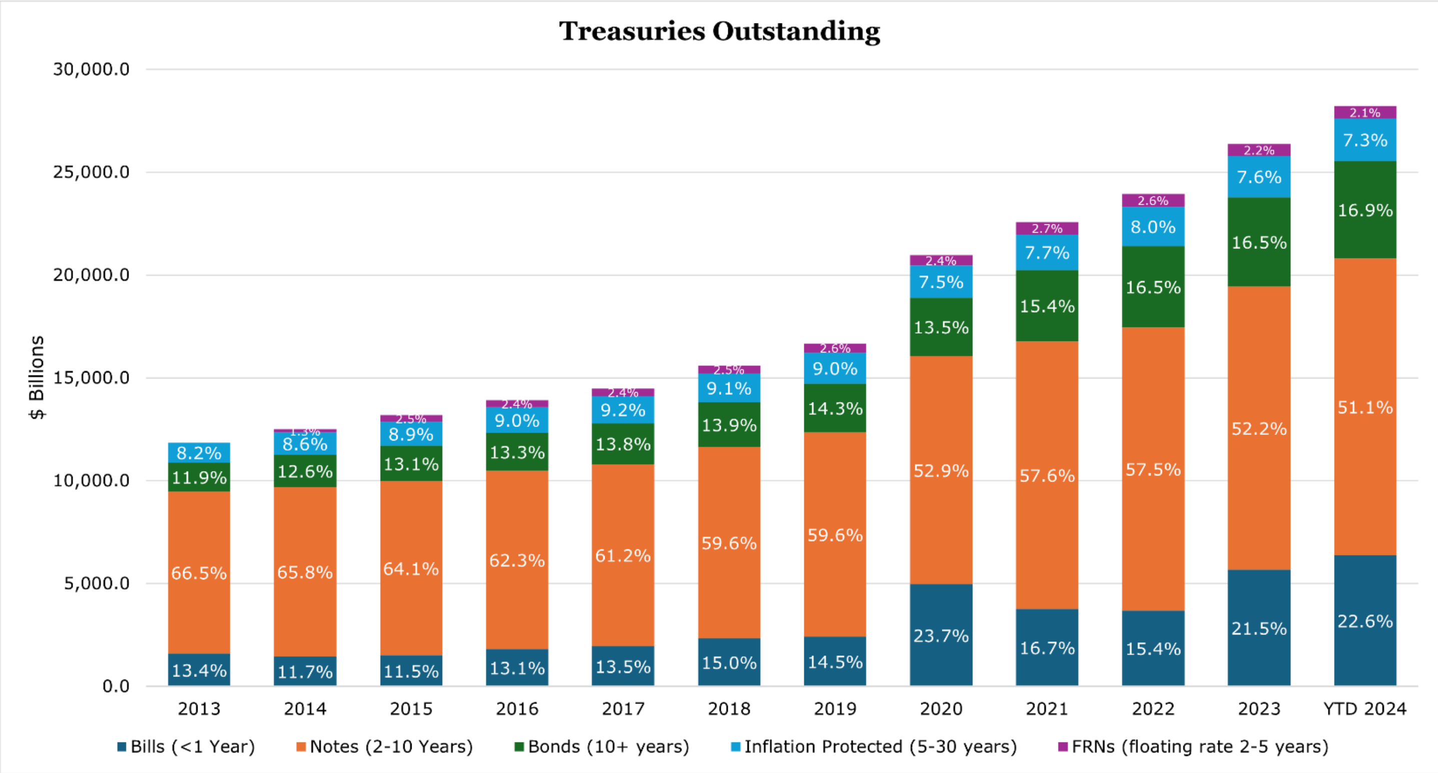
Market Rate is the average of CME FedWatch, JP Morgan Asset Management, and TD Economics.

Rolling Over Treasuries Could Pose a Threat to Market Stability

As we have discussed before, the record pace of new debt issuance on top of the rolling over of short-term issuances could put strain on Treasury markets.

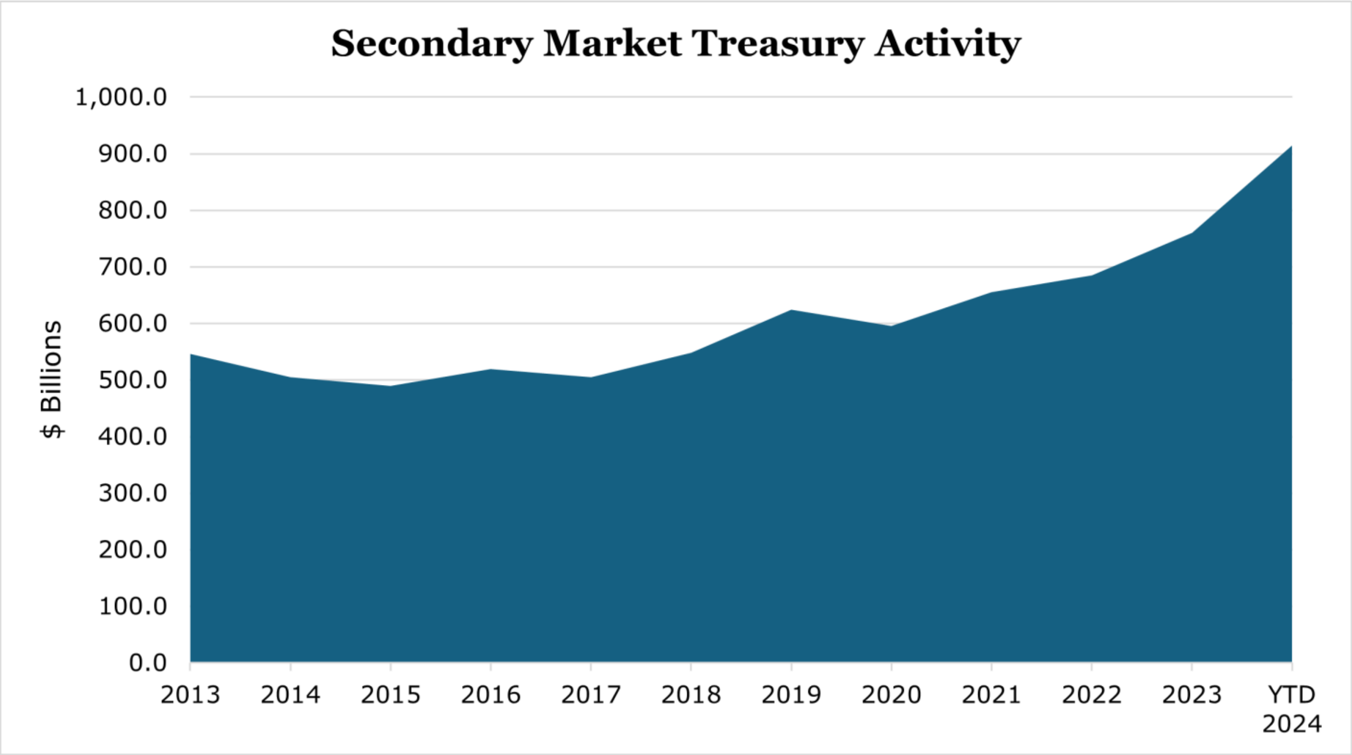


With interest rates high, the Treasury has relied heavily on short-term issuances to manage interest expense. While the volume of short-dated bills granted the Treasury flexibility at the time, it is now stuck with $3 trillion that will need to be rolled over into longer-term issuances. It is likely the Treasury overestimated the pace and steepness of Fed rate cuts and assumed it could get a lower rate by the time it needed to roll over the bulk of its issuances, which has not materialized. The $3 trillion in rollover is on top of the new $2 trillion in issuances that will need to be borrowed for the projected deficit in 2025.



SIFMA, Tradition. YTD as of the End of November 2024.

Analysts expect the Treasury to begin shifting back to a historical level of around 60% Notes (2-10 Year) and 15% Bills (<1 year). Investors who have absorbed much of the short-term issuances like commercial banks, hedge funds and money market funds, may not be willing or able to absorb the same volume of 2-to-10-year issuances, which could push long-term yields even higher if the new supply outstrips demand. With foreign central banks also reducing their treasury holdings, the prospect of treasury market disfunction in 2025 is increasingly likely.



SIFMA. YTD as of the End of November 2024.

The record volume of these issuances has become a structural problem for the Treasury market according to the Federal Reserve Board. While primary dealers are legally required to purchase new Treasuries at auction, they still have internal risk controls that limit how much Treasury inventory they can carry at any given time. If demand from the secondary market is weak, or if dealers exceed their internal caps on how many Treasuries they hold, they may need to sell them quickly at a steep discount. This can translate into high volatility across the market as well as rapidly increase yields across the curve. If this occurs, it may force the Fed to step in and introduce an inverse to its historical "Operation Twist" program by absorbing long-term issuances to prevent a rapid increase in long-term rates.

Flight to Safety, Or Yield-Seeking Behavior?

US-listed ETFs, Year to Date		
	Asset Inflow (% of 2023 AUM)	Net Asset Inflow ($ Millions)
Equity ETF	**10.2%**	**+654,544**
US	11.0%	+561,145
Non-US Developed	8.8%	+60,057
Emerging Markets	3.5%	+8,492
Fixed-Income ETF	**18.3%**	**+279,427**
Collateralized Consumer	108.6%	+22,835
Commodity ETF	**2.0%**	**+2,690**
Specialty ETFs	**84.9%**	**+9,023**
Mixed Allocation	**17.7%**	**+3,358**
Alternatives ETF	**104.9%**	**+44,842**
Bitcoin	~197.8%*	+41,714*

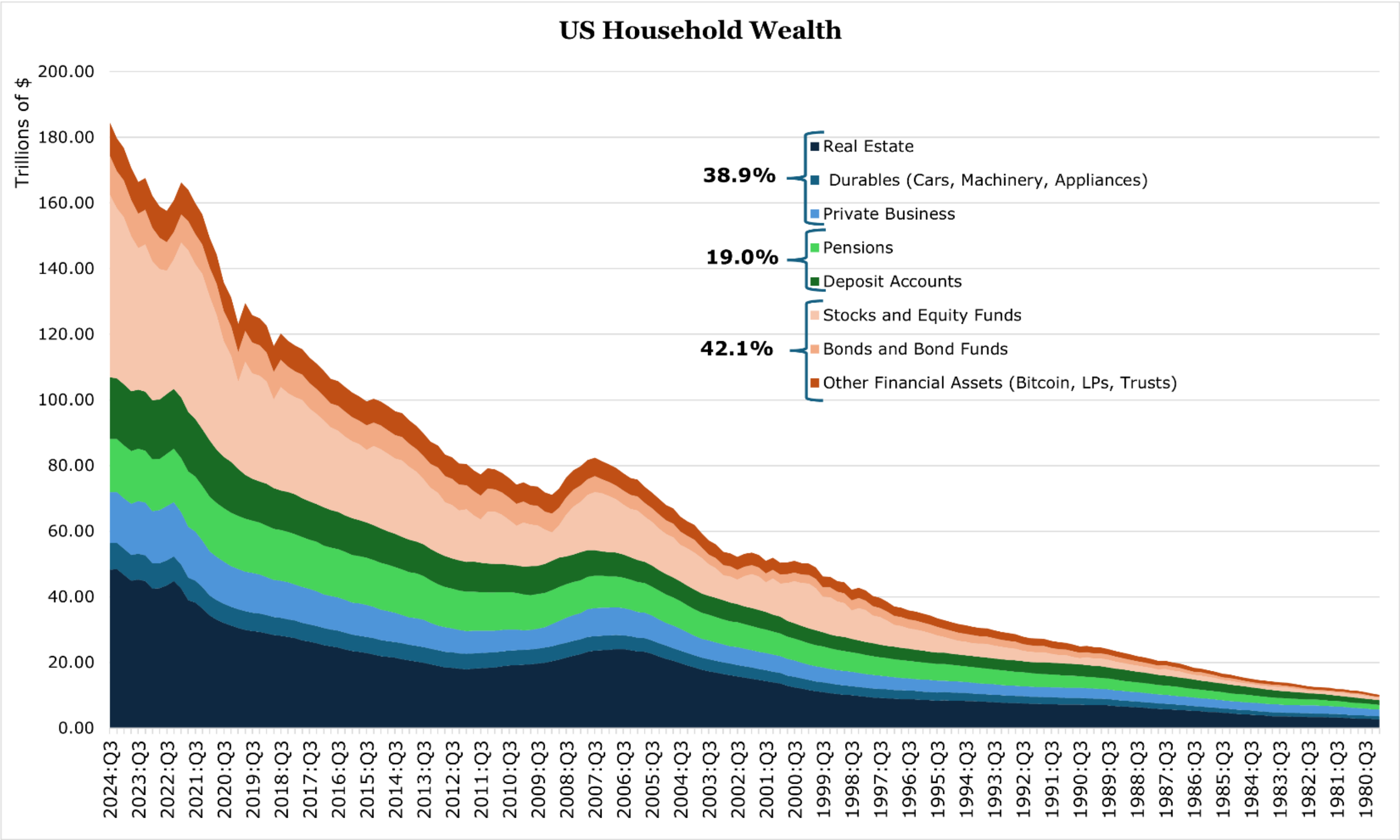
State Street, Bold Report. *While the SEC approved US-listed Bitcoin Future ETFs in October 2021, US-listed spot ETFs were not approved until January 2024.

U.S. ETFs attracted inflows of $115 billion in November, the highest since April 2021. On the political front, U.S. markets rallied after the reelection of Donald Trump as anticipated corporate tax cuts appeared to balance out any anxieties over new tariff proposals. This sharp inflow continues the trend of the US having an outsized share of global financial markets, with US stocks now representing 67% of global equity markets – 16% higher than a decade ago. Increasingly, a large part of the gains in US equity markets lie within just a few names. The top 10 stocks in the S&P 500 now represent 38.7% of the index, driving 55% of its returns in 2024, and 63% in 2023.

Market	Current P/E Ratio	Trailing 10 Year Average
S&P 500	26.9x	18.5x
S&P 500 Ex-Mag 7	18.2x	
United States Total	**26.6x**	**18.8x**
Developed Ex-US	15.3x	14.5x
Emerging Markets	13.1x	13.3x
Global	**21.1x**	**16.3x**

Vanguard, JP Morgan Asset Management, S&P.

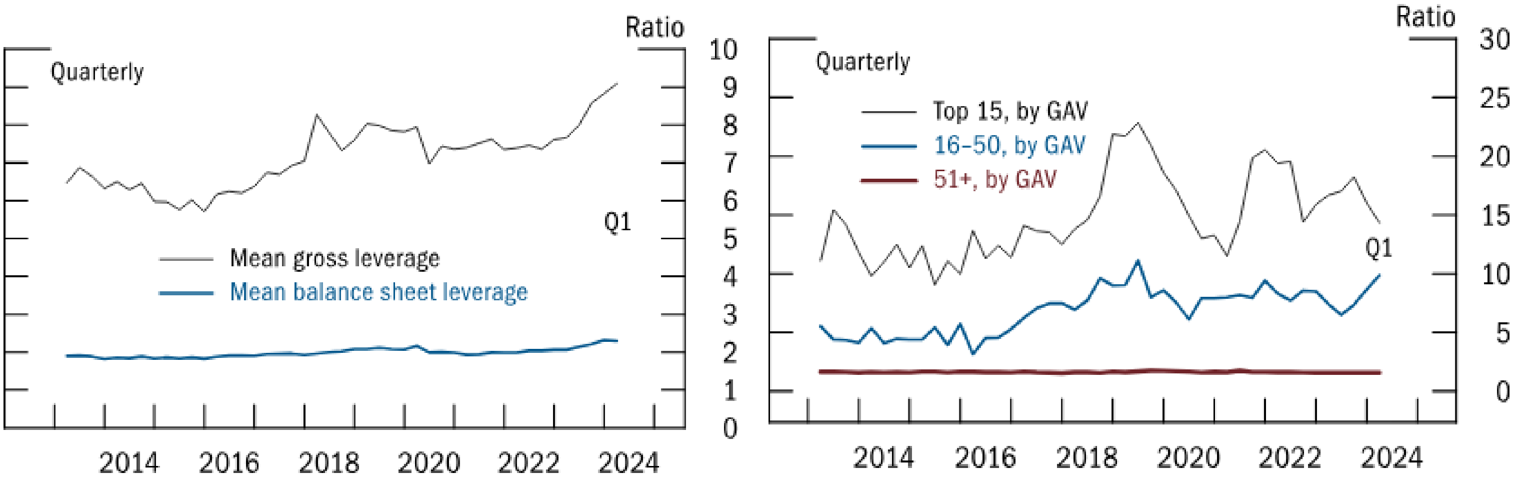
American households now hold record ownership in stocks, with 62% of American households having some form of direct equity exposure. As of the quarter ending September 2024, 30.2% of household wealth is in the stock market, the highest level in US history. Including bonds and alternative assets, households have 42.1% of wealth in areas with at least some direct market exposure.



Federal Reserve Board, Tradition

Meanwhile, demand for alternative investments also surged to record levels. In the immediate post-election environment, Bitcoin ETF inflows crossed $10 billion and climbed to $124.4 billion before a subsequent price drawdown pulled that figure back to $106 billion. Overall, Bitcoin ETFs have seen a remarkable 197.8% year-to-date increase in assets under management. This is the fastest ETF AUM growth in history, spurred by the SEC’s approval of spot Bitcoin trading in early 2024.

It appears that current market dynamics are driven less by a "flight to safety/familiarity" amid global uncertainty and more by a broad-based blend of FOMO (fear of missing out) and yield-seeking behavior.



NY Fed using SEC Data. Gross leverage includes off-balance-sheet items, such as derivative positions.

While hedge funds by their nature are leveraged, the level of this leverage can be used as a proxy for potential volatility. The top 15 hedge funds continue to operate at about 15-to-1 leverage, slightly below their peaks from the COVID era yet still well above their long-term average. Even more striking, mid-tier hedge funds have recently seen a spike in leverage from around 6-to-1 to 10-to-1. Many hedge funds are clustering into already crowded positions chasing outsized gains in a very small number of assets. This convergence of high leverage and narrow positioning is a recipe for heightened volatility. A minor decline in a handful of market leading positions could prompt de-leveraging by hedge funds, amplifying a small price shock into a broader sell-off.

Altogether, a mixture of high-leverage, record high household participation in equity markets, and record-high concentration in equity returns could drastically increase volatility in financial markets and cause future bear markets to have a historically high impact on households.

Debt Ceiling Debacle Returns

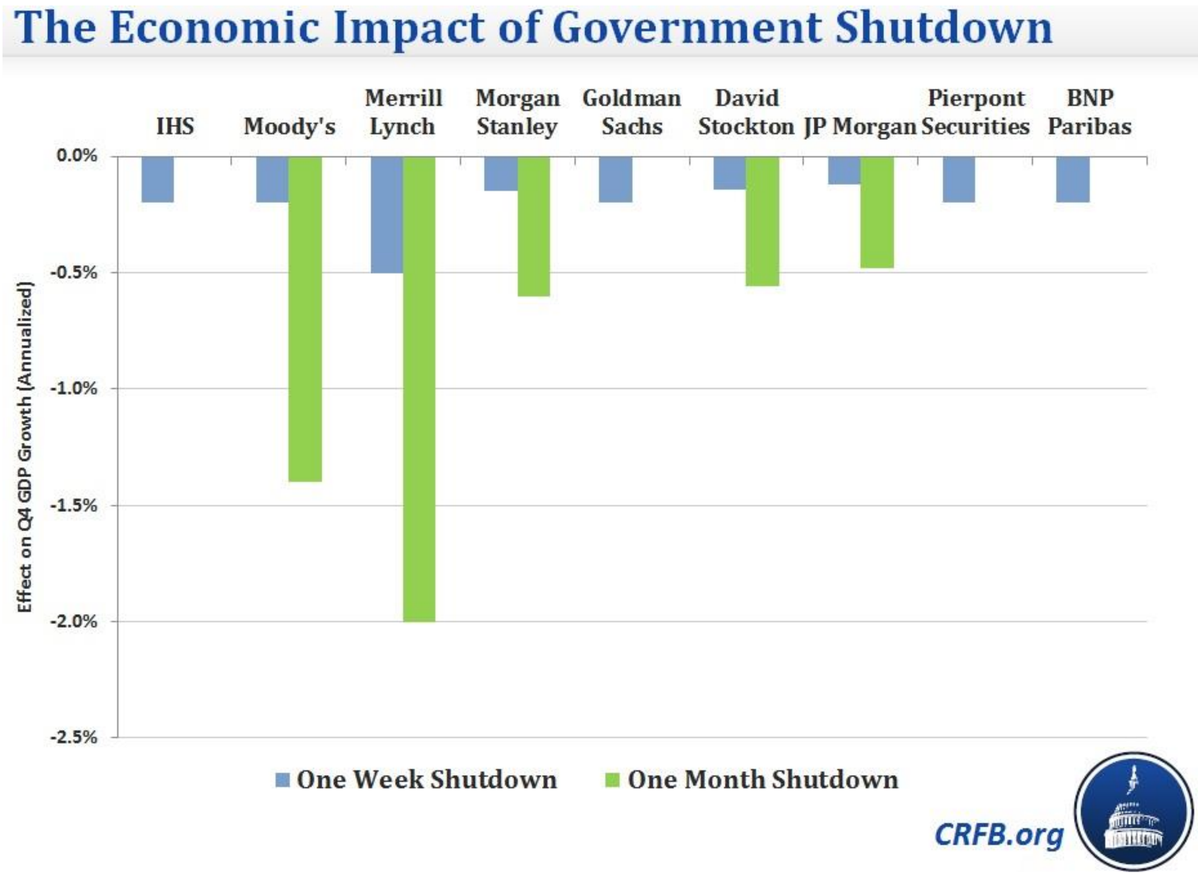
Early in December, Congress passed a bill to maintain current funding levels through March 2025, successfully averting a shutdown. Funding gap shutdowns affect only 27% of the federal budget, money spent on discretionary services. Although the government now has the authorization to spend money, the government needs authorization to borrow money. The debt ceiling is a legal cap on the total amount of money the U.S. government can borrow. In early 2023, the ceiling was suspended until January 1, 2025, in the face of a massive $2 trillion deficit.

However, a debt-ceiling shutdown would effectively halt all public operations within the US.

Service	Budget-Related Shutdown	Debt Ceiling Shutdown
Federal Employees	Delayed payments for employed individuals, contractor work suspended. Military unaffected.	All non-essential employes are furloughed. Military, air traffic controllers, and law enforcement work without pay.
Social Security and Disability	Payments are uninterrupted, new applications may see delays.	Payments halt or will be substantially delayed. Recipients will still accrue and receive back pay once shutdown ends.
Other Benefits (Food Stamps)		Recipients will *not* receive back benefits.
Medicare/Medicaid	Minor service delays, due to contracted support staff being suspended.	Payments to healthcare providers would be limited. Beneficiaries would face restricted access for 'non-essential' care.
Public Health (CDC, FDA)	Uninterrupted.	Only disease outbreak control remains functional. Inspections, approvals and research stop.
Emergency Services (FEMA, Disaster Relief)	Uninterrupted.	Life-or-death operations continue but have no replenishment ability.
Construction and Transportation	Minor delays for new projects, uninterrupted for projects in progress.	Any federally funded project halts disbursement which could impact progression of projects. This is around 15% of total construction spending in the US.
Treasury	No authorization to spend on discretionary items. Payments continue to holders of Treasury securities.	The US enters default.

Secretary of the Treasury Janet Yellen has warned that the US could hit its statutory debt limit as soon as January 14, 2025. Once this is hit, the US Treasury must cease all borrowing operations. The Treasury has cash reserves that should allow it to continue normal operation for some time, though this is likely to be exhausted by June 2025. Once these measures are exhausted, the government will enter an immediate and aggressive shutdown of all discretionary and most non-discretionary services as described in the table above unless the ceiling is suspended or raised.

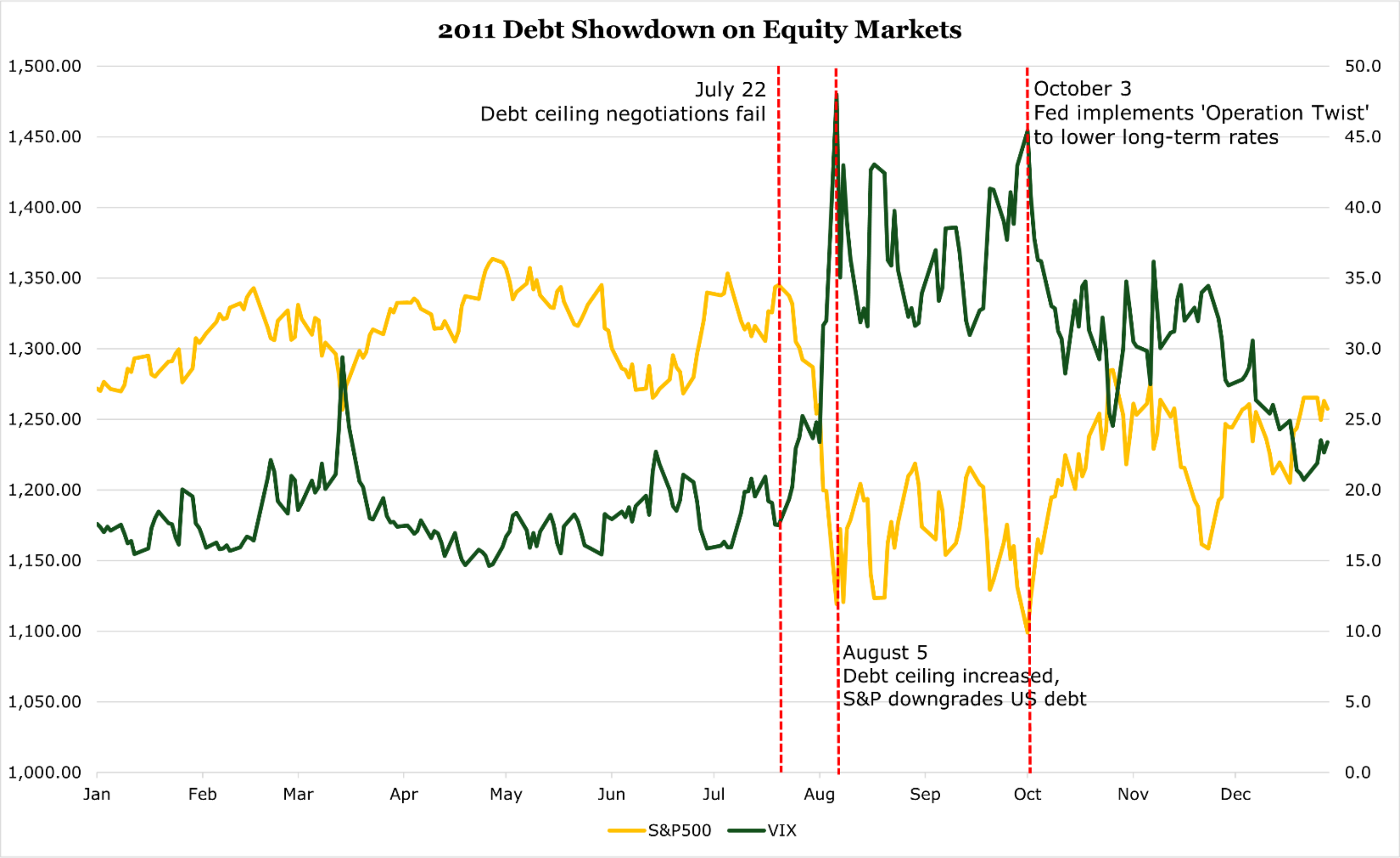
While Donald Trump has endorsed removing the debt ceiling, 38 Congressional Republicans broke ranks with the party and killed the bill that would've extended the suspension another 2 years.



CFB, 2013 Study on NGDP Impacts of Shutdown

Estimates of the comparatively smaller budgetary-shortfall shutdowns impact nominal GDP at an average of -0.3% per week. A debt-ceiling-shutdown would affect nominal GDP by around -1.0% per week, not to mention the turmoil a default would cause in global financial markets.

If the US Government were to enter a default, Fitch warned that affected notes would be given the "D" rating, making them junk, and it would downgrade other US Treasury issuances to CCC or lower. Moody's estimates that the turmoil in financial markets as a result of a US government default would reduce nominal GDP by 4.6%, put 7.8 million Americans out of work, and wipe more than $10 trillion in household wealth as borrowing costs spike and asset values plunge.

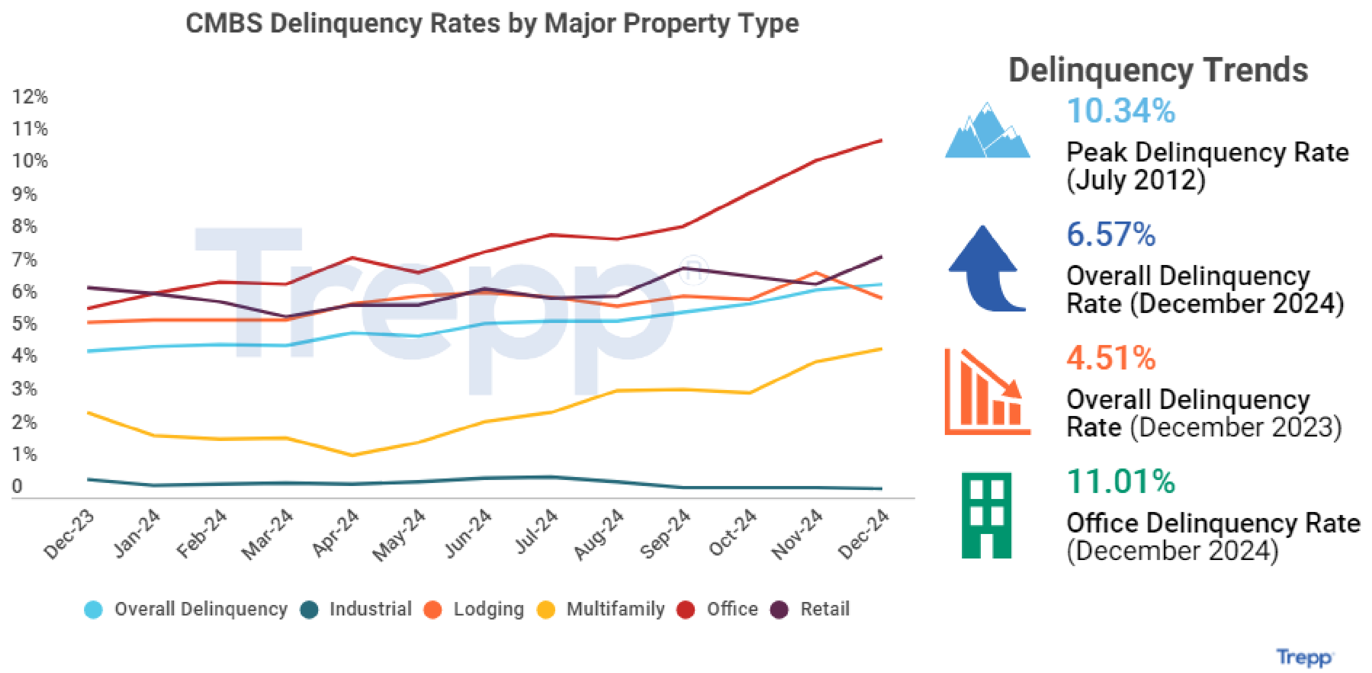


Tradition. Left Axis is S&P, Right is VIX.

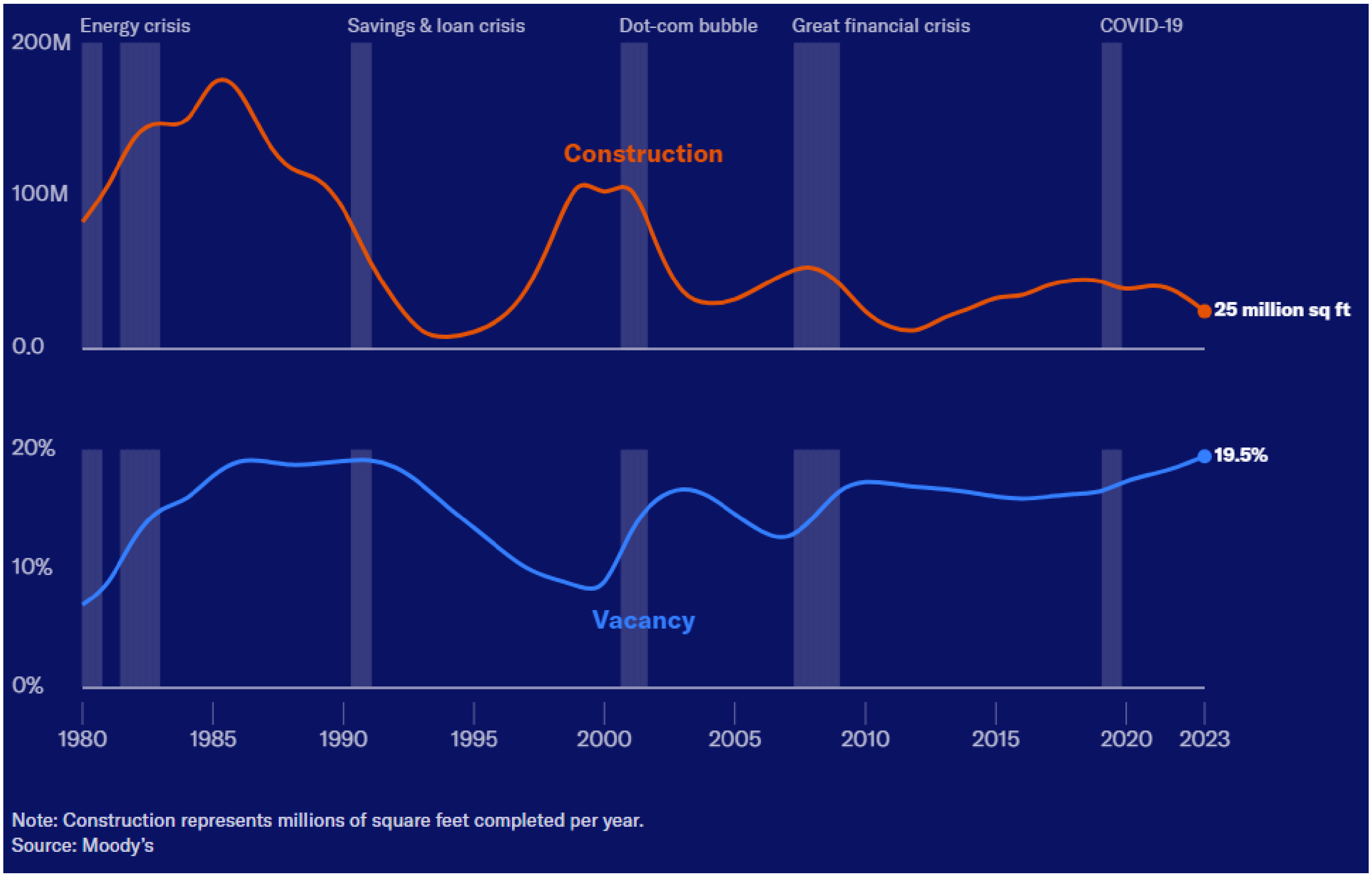
During the 2011 debt ceiling standoff where the US Government came *close* to hitting the ceiling, equity markets suffered significant volatility and a drawdown. Between July 22 when negotiations broke down in Congress and October 3, when the Fed stepped in, the S&P 500 dropped 18.3%, while the VIX (volatility index) spiked in dramatic fashion by 159.4%. While Treasury yields still fell in a 'flight for safety', credit default swaps on US government debt more than doubled.

Return to Office Not Enough: Office Defaults Hit Record Highs

The default rate for US Office real estate has hit near-record highs, with Trepp reporting delinquency rates jumping by 63bps to 11.01% in December, representing $2 billion in value. Total commercial delinquency rates were meaningfully higher at the end of 2024, rising by more than 200bps to 6.57%.

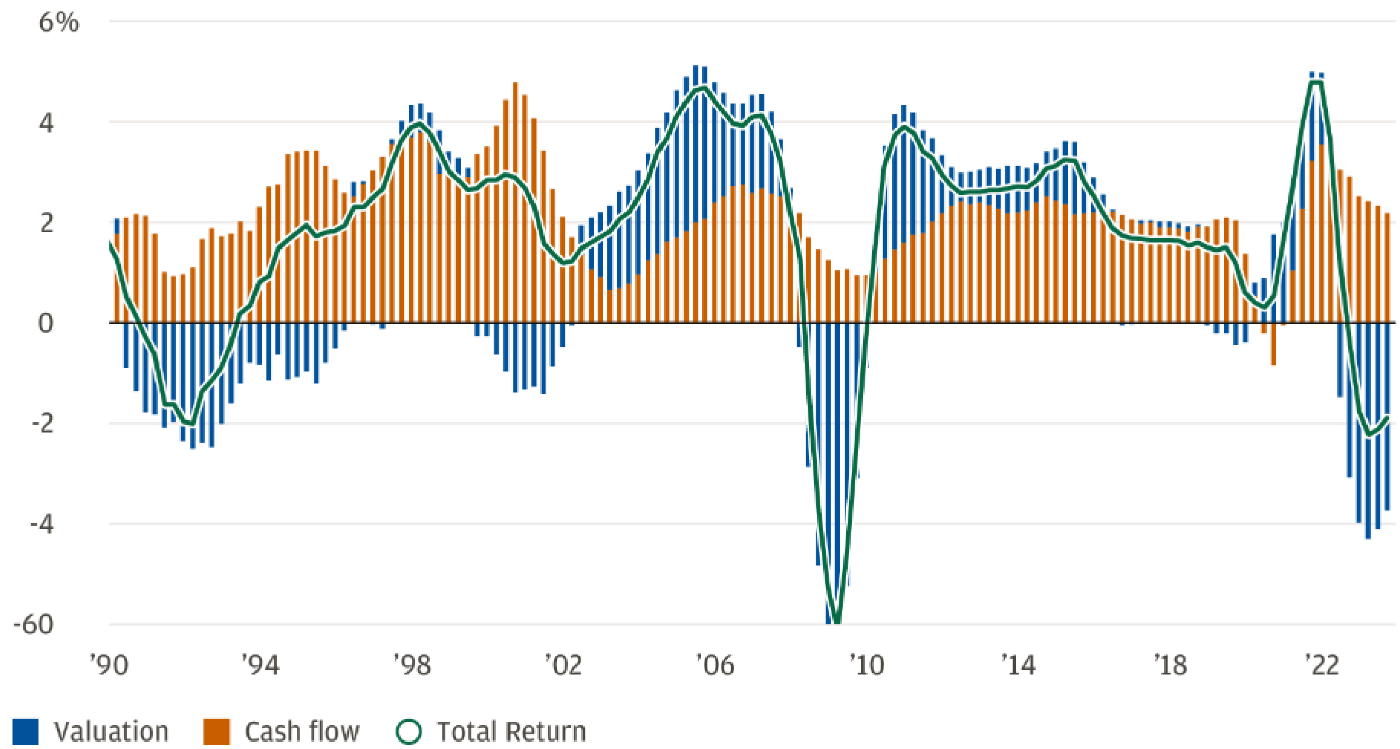


S&P estimates that commercial real estate debt maturing in 2024 carries an average interest rate of 4.3%. By contrast, new debt originated in 2024 averages closer to 6.2%, and likely to creep higher if the 10-year treasury yield continues to increase. Historically, around half of commercial real estate debt has been variable-rate, meaning many owners had been holding for lower rates that never materialized and instead saw their rates increase. Equally, those with high-fixed rate debt will be unable to refinance lower.



Despite 61% of employers now having at least some return-to-office policy the vacancy rate among America's top 50 metros reached 20.1% for office real estate in the first half of 2024. This figure is up 60bps from the end of 2023 and is nearing historic highs. Markets like San Francisco, Chicago, and parts of Manhattan have recorded even higher vacancy levels, with companies hesitant to lease more space, especially amid ongoing economic uncertainties.

In an attempt to avoid the overbuilt era of the 1980s, which led to a similar level of defaults and vacancies, developers have pulled back on new office construction. Yet, even with slower construction, office prices have fallen by about 12% since 2022 which for context the early 1990s has a similar 11% price decrease. However, as demand recovered in the 1990s, vacancy rates decreased, and commercial real estate produced robust cashflows. The difference this time is questions about demand, even as many workers do return to office, many will never return on a daily basis again.



Source: NCREIF. Data as of March 31, 2024.

JPMC Private Banking

However, the market seen in the 90s does not seem to be repeating. Office tenants have leased less space at shorter terms. The average new office lease signed during 2024 is 32% smaller than pre-pandemic, while renewals themselves are down by 21%.

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