



MONTHLY MARKET PULSE — DECEMBER 2024

HIGHLIGHTS

- ▶ **Higher Stock Prices:** Markets were largely encouraged by the U.S. election outcome and proposed policies, specifically tax cut extensions and deregulation.
- ▶ **Small Cap Optimism:** The Russell 2000 is outpacing the S&P 500 by over 4% this quarter and is also outperforming over the past twelve months.
- ▶ **Tariffs:** The President-elect, Donald Trump, has mentioned numerous policies, including immigration and tax cuts, but the one that has gotten a lot of attention recently are tariffs. In this month's *Spotlight*, we look at the impacts on inflation.
- ▶ **U.S. Exceptionalism:** U.S. equities have outperformed the rest of the world by about 25% over the past 2 years, but currently appear expensive compared to the rest of the world.

MONTHLY SPOTLIGHT:
Are Tariffs Inflationary?
 Author: Dan Carter
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MACRO INSIGHTS

Election Fuels Further Upside

Stocks rose significantly in November, adding to already impressive year-to-date gains. The U.S. election results were viewed positively, driven by optimism around the likelihood of deregulation and more favorable tax policies. While U.S. corporate tax rates may not decline from current levels, the 2017 tax cuts, which are set to expire in 2025, have a better chance of being renewed, at least partially.

Small caps led the month's gains, rising nearly 11%, compared to a nearly 6% gain for the S&P 500. These smaller companies derive a larger share of their revenue and profit from the U.S., positioning them to potentially benefit more from favorable corporate tax policies, an "America First" agenda, and the possibility of increased mergers and acquisitions under a new administration.

At the sector level, consumer discretionary performed best, rising over 13%, largely due to Tesla's 38% rise on the month. Financial stocks followed, up 10% on expectations of a more favorable regulatory environment. Industrial and energy stocks also outperformed, while healthcare remained flat amid concerns over increased scrutiny of big pharma following the nomination for the head of Health and Human Services.

While the market has broadly viewed the election results as favorable, there are clear winners and losers, along with lingering uncertainty about the impact of potential tariffs. This month's *Spotlight* explores how tariffs could influence inflation. The market has priced in some probability of broad tariffs on China, especially for companies heavily reliant on Chinese goods. However, which of these threats will materialize remains unclear.

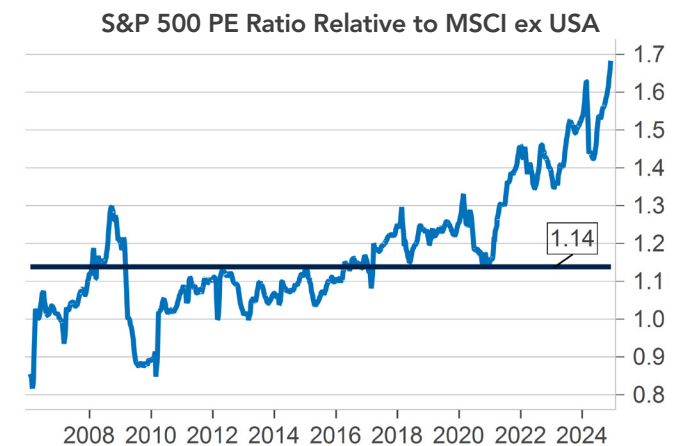
Equity market gains in November further stretched already high valuations in the U.S., especially compared to the rest of the world.

This is reflected in the expanding price-to-earnings ratio premium the U.S. carries relative to non-U.S. markets (see chart below).

Long-term rates declined slightly from the levels seen a month ago. Despite this, expectations remain for modest Federal Reserve (Fed) rate cuts through 2025 (around 0.75%). Should inflation continue to cool and tariffs prove less impactful, markets could end up pleasantly surprised. With a strong earnings season now behind us and economic data showing resilience, much attention is likely to focus on the priorities of the incoming administration.

U.S. Valuation Premium Extends Further

S&P 500 Price/Earnings Ratio relative to the rest of the world's, and median ratio since 2005.



Source: Fort Washington, Bloomberg, and Macrobond.

Chris Shipley, Senior Vice President, Co-Chief Investment Officer
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WHAT TO WATCH

Labor market data will continue to be a focus over the month ahead as investors assess the strength of U.S. consumers. Additionally, investors will monitor incoming inflation figures and implications for Fed policy.

- ▶ The next FOMC meeting is December 18. Markets are currently split between a 25-basis point cut and no cut.
- ▶ With PCE released the last week of November, CPI on December 11 will be the last inflation reading before the Fed's next meeting.
- ▶ Employment reports are continually monitored but with small and mid-size companies accounting for 80% of the U.S. labor force, the NFIB small business optimism index (released December 10) may provide useful insights into these companies.

MONTHLY SPOTLIGHT



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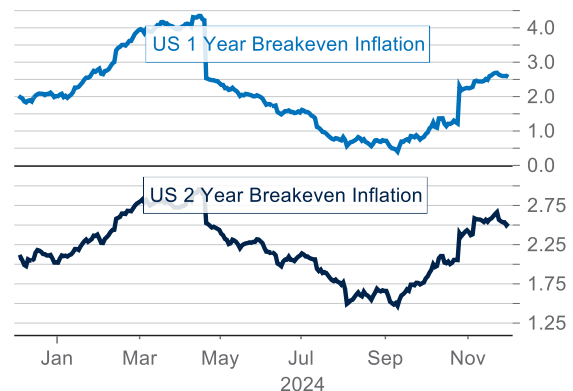
Are Tariffs Inflationary?

Leading up to the presidential election in November, investors began contemplating the impact of many of Donald Trump's policies. One that has gotten a lot of attention since the election is his proposal for tariffs. Trump has proposed a few flavors of tariffs, with the most recent being an 'additional' 10% tax on many imports from China and 25% on all products from Mexico and Canada. Trump had previously proposed a 60% tariff for China, so it is possible that the 10% is in addition to that figure. Nevertheless, we remain cognizant that these tariffs are likely a negotiating tactic to bring country leaders to the table. However, we believe Trump will authorize these tariffs if negotiations don't go his way regarding Mexico and Canada, which means discussions on immigration and drug trafficking.

While there are still a lot of uncertainties, we want to analyze the impact of tariffs on U.S. inflation. To do this, we looked at Trump's most severe proposal of a 60% tariff on China. The positive side of this analysis would mention that imports from China are overwhelmingly goods, and goods inflation is negative in the U.S. right now. Our evaluation indicates that a 60% tax on goods from China would raise aggregate prices by about 0.5-1.0%. This is because goods account for only 1/3 of PCE inflation, and Chinese imports account for only 13% of all goods sold in the U.S. Using these assumptions, one could conclude a 60% tariff on China, taken alone, would not result in meaningfully higher inflation. Additionally, an important distinction is that a single tariff is not inflationary but rather a one-time price level increase, which many investors (and potentially the Fed) would likely look through when analyzing inflation. Separately, if prices for certain products increase significantly, there could be changes in consumer behavior as Americans purchase other products ('substitution effect').

The challenge with tariffs is that global trade is a complex ecosystem with many interconnected pieces. Consequentially, the downside risks of a 60% tariff on Chinese goods are the second or third order effects and their impact on inflation and growth. We would expect China to retaliate to a tariff in some capacity, which has the potential to lead to a larger trade war. There is also a potential that tariffs cause supply chain disruptions as companies shift their operations to avoid additional costs (Trump has mentioned goods produced in the U.S. will not be subject to tariffs). Another difficult theme to predict is the impact on global relations and a possible domino effect from other countries.

While some of these impacts may take time to flow through the global economy, investors have recently increased their short-term expectations for U.S. inflation. We believe inflation expectations have moved too high based on our current anticipation of Trump's policies and understanding of the motivation for these public tariff proposals. Additionally, each country's tariff needs to be analyzed for its impact on specific products or energy consumption. As a result, we will be watching future developments closely for potential impacts on the U.S. macroeconomic landscape and asset prices.










Source: Fort Washington, Bloomberg, and Macrobond.

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CURRENT OUTLOOK

Topic	View	MoM Change	Commentary
Macroeconomic Views			
Economic Growth		↑	<ul style="list-style-type: none"> ▶ Recent economic data has remained strong, led by robust consumer spending, especially higher income earners. ▶ Wage growth, low savings rates, and significant increases in net worth are supporting growth. ▶ The likely extension of the 2017 tax cuts along with lesser government regulation should support consumer and business activity. ▶ Proposed tariffs present downside risk from potential trade wars with our largest trading partners (Mexico, Canada, China).
Inflation		–	<ul style="list-style-type: none"> ▶ Inflation remains on a path toward 2% which is expected to continue as service inflation cools. Additionally, the Fed has expressed their improved confidence in the inflation trajectory. ▶ Market expectations for near-term inflation have increased following stronger than expected economic data and Trump's proposed policies; however, longer-term inflation forecasts remain largely grounded. ▶ Inflation is being driven by shelter and other non-discretionary categories while discretionary inflation is negative.
Monetary Policy		↓	<ul style="list-style-type: none"> ▶ The Fed has cut rates by 75-basis points since September, however strong economic growth and a balanced labor market have reduced consensus expectations for cuts in 2025. ▶ Investors are split on a 25-basis point cut at the December meeting and only expect 50 basis points in 2025. This implies a terminal rate around 3.8%, up from below 2.7% in mid-September. ▶ Recent rate cuts and forecasts for more have begun easing financial conditions.
Fiscal Policy		–	<ul style="list-style-type: none"> ▶ Fiscal policy flexibility is reduced as federal debt levels balloon and higher interest costs consume a larger portion of government outlays. ▶ Deficits are expected to remain elevated under the Trump administration amid extension of the 2017 tax cuts and other policy proposals.
Market Valuations			
Rates		–	<ul style="list-style-type: none"> ▶ Treasury yields were largely range bound during November as investors considered Trump's policy impacts on inflation and economic growth. ▶ We anticipate the magnitude of expected rate cuts will continue shifting with new economic data and executive branch policies, presenting opportunities for tactical adjustments. ▶ Long rates were toward the higher end of our expected range for most of the month but declined to more reasonable levels by month-end.
Credit		–	<ul style="list-style-type: none"> ▶ Credit spreads remain below historical averages as the market anticipates a soft/no landing scenario and plans for more rate cuts from the Fed. ▶ We believe current fixed income valuations are expensive, and credit spreads represent little upside. ▶ Investment grade spreads (10yr BBB Industrials) ended November at their 9th percentile and high yield (single B corporates) at their 1st percentile, since the 1990s.
Equity		–	<ul style="list-style-type: none"> ▶ Volatility has eased in the aftermath of the election, while equity indices continue to reach new highs. As a result, equity valuations continue to be stretched as the S&P 500 increases, up 28% this year and over 62% since 2022. ▶ Market breadth has improved of late, with value and small caps outperforming in the second half of the year. Small cap performance over the past month is thanks to optimism around U.S. corporate tax policy, an "American First" agenda, and increased M&A activity. ▶ 2025 earnings expectations may be difficult to achieve even in the soft-landing scenario for the economy.

MARKET DATA & PERFORMANCE | AS OF 11/30/2024

U.S. Snapshot	Current	6 Months Prior	1 Year Prior
Core Inflation (YoY%)	2.8	2.7	3.2
Unemployment Rate	4.1	4.0	3.7
Real GDP (YoY%)	2.7	2.9	3.2
Retail Sales (YoY%)	2.8	2.6	4.0
30-Year Mortgage Rate	6.8	7.0	7.2
10-Year Treasury	4.2	4.5	4.3
US Corporate IG Yield	5.1	5.5	5.6
US Corporate HY Yield	7.1	8.0	8.4

TOTAL RETURNS

Asset Class	MTD	QTD	YTD	1 Year	3 Years*	5 Years*
Equity						
Russell 3000 Index	6.7%	5.9%	27.7%	34.5%	10.5%	15.2%
S&P 500 Index	5.9%	4.9%	28.1%	33.9%	11.4%	15.8%
S&P Midcap 400 Index	8.8%	8.0%	22.7%	33.4%	9.3%	12.6%
Russell 2000 Index	11.0%	9.4%	21.6%	36.4%	5.0%	9.9%
MSCI World Index	4.6%	2.6%	22.3%	28.4%	9.3%	13.0%
MSCI World Excluding US	0.3%	-4.8%	8.1%	14.1%	5.1%	6.9%
Fixed Income						
Bloomberg US Aggregate	1.1%	-1.4%	2.9%	6.9%	-2.0%	0.0%
US Corporate Investment Grade	1.3%	-1.2%	4.0%	8.4%	-1.6%	0.7%
US Corporate High Yield	1.2%	0.6%	8.7%	12.7%	3.7%	4.7%
Emerging Market Debt	1.6%	0.0%	8.6%	14.1%	0.4%	0.9%
US Treasury (7-10 year)	1.0%	-2.5%	1.3%	5.8%	-3.6%	-1.0%
Cash	0.4%	0.8%	4.9%	5.4%	3.8%	2.4%

Source: Fort Washington and Bloomberg. *Returns longer than 1 year are annualized. Past performance is not indicative of future results.

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