REAMS ASSET MANAGEMENT
A Division of Scout Investments

Reams Asset Management

2025 Investment Outlook

While the holiday season can mean many things to many people, omnipresent shopping and rank commercialism have been ubiquitous throughout much of the world at the end of each calendar year. While these activities may distort from the true spirit of the holidays, certainly there is an innocent charm in observing children anticipating gifts from Santa and in the joy of giving and, yes, receiving presents that have been wished for. Hopefully these transactions are in exchange for good behavior for the year elapsed or to come, at least insofar as parents can have wishes granted!

Participants in the U.S. capital markets have had their own list of desired presents over the past two years: chiefly, Federal Open Market Committee (FOMC) federal funds rate cuts to ease financial conditions and stimulate business investment and economic activity. The fixation with rate cuts has always been something of a parlor game, with markets attempting to discern U.S. Federal Reserve (Fed) statements and commentary from various FOMC governors, and to position accordingly.

Fed Chair Jerome Powell and the FOMC did not deliver on all of the desired gifts in 2024, as just one 50-basis point (bp) cut and two 25-bp cuts materialized during the year. Inflation, while abating, did not drop to the Fed's stated target, and unemployment remained low with the underpinnings of a relatively strong U.S. economy. Equity markets nevertheless cheered both the rate cuts they received (and expectations for more to come, albeit at a slower pace) as well as strong corporate earnings and economic data. Returns on the S&P 500 Index were a robust +28.06% after 11 months, a second consecutive impressive year. Risk assets and spread products followed suit with an increase in "animal spirits" broadly. This was only intensified after the November election of President Trump and some needed certainty on the political climate moving forward.

Interest rates, by contrast, were highly volatile throughout the year and remain so entering the new year. The disparity between interest rate volatility, which has whipsawed throughout the year, versus equity and credit spread volatility, which has remained eerily quiescent, is stark and noteworthy. How this seeming contradiction plays out in 2025 will be key to determining if capital markets continue their two-year ascent.

Thus, uncertainty on the future path of interest rates remains elevated going into 2025. Will investors get the "presents" they want, with an accommodative Federal Reserve delivering additional fed funds rate cuts, and can that even be feasible without the economy retracting if not spilling over, however briefly, to a recessionary state? The adage, "Be careful what you wish for – you just might get it!" could be true in this instance. Capital markets continue to price in an extremely benign "soft landing" whereby inflation falls to target and yet the economy continues to soldier along at an above-trend growth rate. Whether this is achievable, or a mere wish, will be revealed in the year to come.

Reams Key Themes for 2025

What is the consensus viewpoint?

For 2025, surveyed economists (per Bloomberg, as of December 15, 2024) collectively forecast U.S. Gross Domestic Product (GDP) growth of +2.10%, which reflects a modest slowing from the expected 2.70% GDP growth of FY 2024. Global growth of +3.10% stays largely in line with current trends and shows China continuing to prop up its slowing economy and thus avoiding a calamitous recession. The Consumer Price Index is estimated to moderate to 2.40% year over year, still above the Federal Reserve's stated 2% target but, if it materializes, would be small enough to justify FOMC fed funds rate cuts. Unemployment is expected to increase to 4.30%, a small tick upward but still reflecting the underpinning of a strong U.S. economy. New home sale estimates are at +736,000, a modest increase based on slightly higher levels of new construction, though this is likely not enough new supply to fundamentally ease the housing affordability picture. Much like last year, these consensus forecasts all converge to the "soft landing" or so-called Goldilocks scenario suggestive of a slightly slowing economy when viewed from very strong starting levels.

Economists also forecast that the fed funds rate, at 4.58% as of December 15, 2024, will fall to 3.60% by year-end 2025. Note this year-end rate is not off the predicted level from a year ago, as the pace of rate cuts in 2024 disappointed meaningfully. The 10-year U.S. Treasury rate is estimated to end 2024 at 4.10%, just inside

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of current levels and still higher than what was forecast for 2024 year-end. Front-end rates may be more sensitive to fed funds rate action, but overall, the yield curve normalization that we saw in 2024 is expected to continue.

What is the downside case (in interest rates) to consensus?

- Strong realized growth in the U.S. along with optimism about growth prospects driven by the new administration have pushed interest rates, along with risk assets, higher. On average over the course of 2024, the market was pricing in about 115 bps in cuts over the following 12 months, more than twice the amount priced in as of mid-December, so there is certainly room for the market to reprice the front end of the yield curve more aggressively, all else being equal.
- While there have been month-over-month gyrations in the labor market, we do see a clear pattern of labor demand that is weakening in the cyclical parts of the economy. While the current pace of weakening in the labor market is slow, the non-linearities in labor market dynamics could drive unemployment higher and lead to lower interest rates.
- Global ex-U.S. growth has not been on strong footing, with the European Union and China both running below trend growth. The European Union has been plagued by higher energy costs since the Ukraine/Russia war began and has been on the back foot given a weak backdrop for global manufacturing. China is suffering from a prolonged slowdown in the local real estate market and a weak external environment for its export products. The added uncertainty from the new U.S. administration's trade policy will likely be a factor that leads to further weakness in global growth. A more pronounced slowdown in the external environment will have an impact on U.S. growth and interest rates.

What is the upside case (in interest rates) to consensus?

- As discussed above, the consensus expects growth to remain strong and inflation to keep falling toward target in 2025. However, wage growth, a key determinant of future inflation, has started to head back higher with year-over-year (YoY) growth reaching the cycle low in July 2024. Unless labor productivity continues at its above-trend growth rate, the current YoY wage gains of 4% might not be compatible with the Fed's 2% inflation target. While the market expects the federal funds rate to keep falling, sticky inflation could cause the market to reassess the future path of the federal funds rate.
- The immigration and trade policy proposals of the incoming administration, if enacted, could also drive the nominal interest rate higher through the inflation expectations component. The supply of labor from higher immigration has been a key factor that has allowed the labor market to get to better balance. Lower labor supply, all else equal, could pressure wages higher and lead to higher inflation. In addition, while tariffs on imported consumer goods are likely to lead to only a one-time increase in prices, the increased uncertainty could lead the Federal Reserve to slow the pace of its cutting cycle as an insurance policy given the above-target inflation that the United States has already experienced.
- Higher deficits and the corresponding free float of government bonds that need to be absorbed by private investors continue to be a concern for capital markets. The incoming U.S. administration's proposals for reducing the tax burden on businesses and individuals are more concrete, but the corresponding actions needed to finance those deficits are less definitive. Further deterioration on the fiscal side will likely push interest rates higher. The net supply of high-quality government bonds outside the United States is also likely to increase next year with higher deficits and central bank quantitative tightening in Europe and Japan being the drivers. All else equal, this will also pressure interest rates further out the curve in the United States.

Reams Macro Positioning into 2025

At Reams, we remain constructive on the broader fixed income markets. Real rates continue to look attractive by historical measures. After inflation, the ability to grow purchasing power by 1.50% to 2.00% per annum is not insignificant, and to us represents a guiding tenet. In the mindset of "taking what the market is giving," risk-free U.S. Treasury bonds are yielding far more than they did throughout most of the past 15 years, and there is no necessity to overextend, thereby reaching for yield down the quality curve. Currently, certain spread products appear expensive, particularly within corporate bonds. However, opportunities within securitized products and non-USD markets leave us

plenty to do while awaiting better valuations in corporate credit. Holding true to our opportunistic nature and value disciplines, we are positioned to remain nimble to respond to dislocations and volatility in the marketplace.

Global Rates and Currencies Outlook 2025

In 2024, resilient U.S. economic data, a shallower monetary policy easing by the Federal Reserve, and trade policy uncertainty have kept the U.S. dollar (USD) well supported. The Swedish krona and Norway krone had the biggest losses within developed markets, while the Brazilian real and Mexican peso underperformed within emerging markets.

Looking forward, while the U.S. dollar is overvalued on most measures, it is hard to see a significantly weaker USD given a stronger U.S. growth outlook relative to the rest of the globe, a healthy yield advantage, and uncertainty with regard to U.S. trade and fiscal policy. Similar to the last three years, we expect that investors will need to be tactical in terms of their outright U.S. dollar exposure to have a chance at being successful.

Our preferred long expressions are in Latin America and developed market (DM) commodity currencies that screen relatively cheaper in our composite valuation measures and are ranked highly in terms of carry. We believe that this mix could outperform in this environment where U.S. growth is stable and risk premia are low in most other asset classes.

Our preferred short expressions are in manufacturing-heavy economies that also have lower short-term interest rates in Asia and DMs. Global manufacturing is likely to remain weak given broadly restrictive monetary policy and weak global growth impulses. The increased likelihood of tariffs and counter tariffs being implemented is likely to further dampen sentiment, adding to the depreciation pressure on these currencies.

Securitized Sector Outlook 2025

During 2024, agency mortgage performance lagged most other fixed income markets. Interest rate volatility continued to be a driving theme for the overall fixed income market and securitized products, specifically, throughout the year. This volatility was a significant factor in the relative underperformance of agency mortgages versus other risk assets. As a result of the ongoing volatility in the U.S. rates markets, agency mortgages have remained attractive, in some cases at historically wide levels. In addition, given that agency mortgages serve as a valuation benchmark within securitized products, other securitized sectors have in turn offered attractive valuations throughout the year. These sectors specifically include asset-backed securities, collateralized loan obligations, and non-agency mortgages.

The housing market and the U.S. consumer have proven extremely resilient during the year. After the Fed-suppressed rate environment over the last decade-plus, the average outstanding residential mortgage rate remains well below the current rate available. This has led to lower housing turnover as homeowners are reticent to part with their historically low-rate mortgages. This reluctance of homeowners to sell, coupled with higher mortgage rates and a higher cost to borrow, have reduced the available supply of homes and incidentally created a strengthening in housing prices, despite the conventional wisdom that higher borrowing rates may lead to lower home values. At the same time, unemployment remains low, the stock market is at or near all-time highs, and household balance sheets remain healthy. This fundamental strength in housing and the U.S. consumer is supportive of securitized products, as lending such as auto, credit card, and housing remains fundamentally robust as the underlying asset base of this market.

The commercial mortgage market, in contrast, continues to work through the decline in demand, and coinciding supply overhang, as well as higher financing rates and stressed valuations. In addition, the pandemic's impact continues to change demand for commercial properties, particularly for office space, which has led to an increase in vacancies, lower valuations, and less certainty around loan refinance availability. Delinquencies are elevated in some sectors of the commercial market, and the number of loans extending beyond their expected maturity is increasing. While the bar remains high for increased investments within the commercial mortgage market, it is an area where we are carefully studying fundamentals and structural nuance that may provide opportunity in the coming year.

At Reams, the volatility in securitized products in 2024 led to several investment opportunities. Today, we believe there are three primary advantages worth considering in securitized products:

agency mortgages and other securitized sectors remain attractive on a historical basis and when compared to other fixed income sectors;

1. the shift from other fixed income instruments into securitized products continues to increase portfolio credit quality as we focus on AAA-rated and agency mortgage securities; and
2. we believe positioning in agency mortgages, and certain non-agency sectors, increases the liquidity profile for our portfolios.

These are some of the primary reasons we believe securitized products will remain in focus for our portfolio positioning.

Corporate Sector Outlook 2025

Once again, corporate bonds have proven to be a resilient sector of fixed income with strong ongoing demand. Aided by consistently favorable technical dynamics, corporate spreads tightened substantially for the year, led by a Q4 rally, to finish November -26 bps tighter year to date for the Bloomberg U.S. Corporate Aggregate Index. This translated to excess returns of +252 bps for the sector versus holding comparable U.S. Treasury positions.

Investment grade new issuance was notably above 2023's levels at approximately $1.4T as of the end of November, as issuers found strong demand for new supply despite borrowing rates higher than during much of the past decade. Most forecasts are for similar levels of issuance in 2025. We believe that U.S. policy will likely be pro-business with the incoming administration, particularly with regard to taxes and regulation, which could help financial issuers most of all. We anticipate a more lenient disposition on mergers and acquisitions (M&A), which has a mixed impact to many companies and credit holders. Tempering these positives, the threats of additional tariffs and restrictive immigration policy could hurt company margins and increase cost structures.

Corporate balance sheets continue to look exceptionally strong, though de-leveraging is likely at an end for most sectors and debt paydown is unlikely to be a priority for many Fortune 500 companies in the year ahead. Also, late-cycle behavior, such as increased shareholder returns (share repurchases, increased dividends) and potentially questionable M&A combinations, could prove detrimental to bondholders. While such credit-deteriorating events have been thankfully rare in the four years following the COVID-19 pandemic, we anticipate an uptick in such balance sheet degradation in 2025. This suggests individual issue and sub-sector selection will take on greater importance in the year to come.

At Reams, we have continued to moderate corporate exposure, and particularly among idiosyncratic, higher-beta, weaker credits. With spreads having touched levels not seen since 1998, valuation is not terribly compelling. That said, the technical measures that have led to such spread compression show no signs of abatement, and U.S. corporate earnings have been doggedly resilient, all of which suggests this low level of additional spread compensation may persist for some time to come. We favor defensive areas such as utilities versus industrials, and broadly favor limited exposure to international markets, preferring the U.S. economy (and thus, its consumer) to that of Europe or China. Our preferred route for high yield exposure continues to be to utilize the credit default swap index derivative instrument for short-term tactical exposure, but only when we believe valuations warrant.

For more information regarding Reams Asset Management, please contact us at 463.777.3900.

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Bond prices and yields are subject to change based upon market conditions and availability. If bonds are sold prior to maturity, you may receive more or less than your initial investment. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features.

Securitized products, such as asset-backed securities (ABS) and mortgage-backed securities (MBS), are created by pooling loans from a variety of sources and issuing bonds that are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates.

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Definitions

Animal spirits is a phrase used to describe how human emotion, irrational thinking, and a herd mentality among market participants can drive financial decision-making and investing in uncertain environments and volatile times. British economist John Maynard Keynes coined the phrase in his 1936 book, "The General Theory of Employment, Interest, and Money."

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

Beta is a measure of the volatility or systemic risk of a security, group of securities, or portfolio compared with the market as a whole.

A consensus estimate is a forecast of a public company's projected earnings, the results of a particular industry, sector, geography, asset class, or other category, or the expected findings of a macroeconomic report based on the combined estimates of analysts and other market observers that track the stock or data in question.

The U.S. Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The U.S. Bureau of Labor Statistics bases the index on prices of food, clothing, shelter, fuels, transportation, doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living. Prices are collected each month in 75 urban areas across the country from about 6,000 households and 22,000 retailers.

A credit default swap is a financial derivative or contract that allows an investor to "swap" or offset a credit risk with one owned by another investor. Credit default swaps act like insurance policies in the financial world, offering a buyer protection in case a borrower defaults on credits such as corporate bonds, mortgage-backed securities, municipal bonds, or emerging market bonds.

A credit spread is the difference in yield between a U.S. Treasury bond and another debt security with the same maturity but different credit quality. Also referred to as "bond spreads" or "default spreads," credit spreads are measured in basis points, with a 1% difference in yield equaling a spread of 100 basis points. Credit spreads reflect the risk of the debt security being compared with the Treasury bond, which is considered to be risk-free. Higher quality securities have a lower chance of the issuer defaulting. Lower quality securities have a higher chance of the issuer defaulting.

Currency carry refers to the yield of an individual currency relative to other currencies. A high-carry currency is one with a high prevailing interest rate.

Currency depreciation is the fall in value of a currency relative to its exchange rate against other currencies.

Cyclical securities have prices influenced by macroeconomic changes in the economy and are known for following the economy as it cycles through expansion, peak, recession, and recovery.

Defensive sectors include companies that tend to have a constant demand for their products or services, making their operations more stable during different phases of the business cycle.

The federal funds rate, known as the fed funds rate, is the target interest rate set by the Federal Open Market Committee of the U.S. Federal Reserve. The target is the Fed's suggested rate for commercial banks to borrow and lend their excess reserves to each other overnight.

The Federal Open Market Committee (FOMC) consists of 12 members: the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis. The FOMC holds eight regularly scheduled meetings per year at which it reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.

Free float of U.S. government bonds refers to the total outstanding amount of U.S. Treasuries that are available for private investors to buy and sell on the open market.

Goldilocks is a term used to describe economic data suggesting that an economy is neither too hot nor too cold.

Gross domestic product (GDP) is the total value of goods and services provided in an economy during a specified period, often one year.

High yield bonds have credit ratings below BBB- from Standard & Poor's or below Baa3 from Moody's.

The inflation target of the U.S. Federal Reserve is the rate of price increases that the Fed prefers to see to ensure the economy will remain stable. Generally, the Fed's target rate is 2%, as measured by the Personal Consumption Expenditures (PCE) Price Index.

Investment grade (IG) refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

A long expression in currency trading reflects the buyer's expectation that a currency or currency option will increase in value over time.

Nominal interest rates are interest rates that are not adjusted for inflation.

Quantitative tightening, also known as quantitative tapering, refers to the attempt by central bankers to reverse the effects of quantitative easing (QE), which is a form of unconventional monetary policy in which a central bank purchases longer-term securities from the open market in order to increase the money supply and encourage lending and investment. In quantitative easing, buying securities adds new money to the economy, and also serves to lower interest rates by bidding up fixed-income securities. It also expands the central bank's balance sheet. In quantitative tightening, reducing those purchases is a policy primarily aimed at interest rates and at influencing investor perceptions of the future direction of interest rates.

A real interest rate is an interest rate that has been adjusted to remove the effects of inflation. Once adjusted, it reflects the real cost of funds to a borrower and the real yield to a lender or to an investor. A real interest rate reflects the rate of time preference for current goods over future goods. For an investment, a real interest rate is calculated as the difference between the nominal interest rate, which is not adjusted for inflation, and the inflation rate.

A risk-free interest rate, also known as a risk-free rate of return, is a theoretical interest rate of an investment that carries no risk. Real risk-free rates are calculated by subtracting the rate of inflation from the yield of the Treasury bond matching the duration of the investment in question.

Risk assets refer to investments such as equities, commodities, high-yield bonds, real estate, and currencies, where the value may rise or fall due to fluctuating interest rates, changes in credit quality, default risks, supply and demand disruption, and other factors.

A short expression in currency trading reflects the buyer's expectation that a currency or currency option will fall in value over time.

A soft landing occurs when a central bank successfully adjusts interest rates to reduce inflation and slow economic growth while avoiding a recession.

Spread compression takes place when a credit spread narrows. This often happens when strong demand brings down the yield on a higher-yielding bond. A credit spread is the difference in yield between a U.S. Treasury bond and another debt security with the same maturity but different credit quality. Also referred to as "bond spreads" or "default spreads," credit spreads are measured in basis points, with a 1% difference in yield equaling a spread of 100 basis points. Credit spreads reflect the risk of the debt security being compared with the Treasury bond, which is considered to be risk-free. Higher quality securities have a lower chance of the issuer defaulting. Lower quality securities have a higher chance of the issuer defaulting.

Spread products are securities with returns measured in terms of how their spread changes relative to U.S. Treasuries. They include securitized bonds, which consist of income-generating pools of assets, such as mortgage-backed securities or asset-backed securities.

Sticky is a term used to describe measured data that is slow to change, in contrast to faster-changing or more variable data.

Tactical trading refers to relatively short-term investing decisions made in response to expected trends or changes in the market based on fundamental and technical analysis.

Technicals refers to technical indicators of historic market data, including price and volume statistics, to which analysts apply a wide variety of mathematical formulas in their study of larger market patterns.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. Investors and market analysts watch certain yield curves for signs of inversion, when yields for longer-term debt instruments fall below yields on short-term debt with the same credit quality. Inversions are watched as potential signs of a weakening economy and in certain cases, a harbinger of recessions.

Indices

The Bloomberg U.S. Corporate Aggregate Index is the corporate component of the Bloomberg U.S. Credit Index, which includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common large-cap stocks. It is a market-weighted index calculated on a total return basis with dividends reinvested. The S&P 500 represents approximately 80% of the investable U.S. equity market.

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