GenTrust Outlook | 2025

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Executive Summary

Welcome to our 13th Annual Investment Outlook. Some themes we discussed in our original 2012 Outlook such as fiscal stress and US exceptionalism remain relevant today, while others such as AI and geopolitics have evolved over the years.

Coming into 2024, many economists were predicting a recession because historically one has typically followed such a large move higher in interest rates. Despite these predictions, growth was strong in the US led by a robust consumer and labor market, while inflation continued its downward trend. As a result, 2024 was a great year for financial assets as global equities are up 22.0%, while bonds are up 3.5%[1]. For 2025, the market expects the Federal Reserve will cut rates by 75bps and inflation is expected to remain around its current levels of 2.7%. S&P 500 earnings are expected to be $272, up 13% from '24 estimated earnings of $240. At SPX 6,090, $272 of forward earnings would imply a forward P/E of over 22, although this number is slightly distorted by the fact that the forward price/earnings of the Mag7[2] stocks is over 30.

Looking forward to 2025, we believe the key questions will be:

- *What impact will the Republican sweep have on policies such as tariffs, deficits, and deregulation?* Our view is that future tariff policy will likely consist of strong rhetoric followed by more subdued policy action. We also believe budget deficit concerns will be a smaller issue as markets instead focus on the positive impact of deregulation. However, deregulation has historically not had the impact expected.

- *Will the AI boom continue or will cracks in the promise of the technology be shown?* Much is currently priced into AI stocks, so while we believe very much in the technology, the current pricing makes it difficult to have a large allocation to the industry.

- *Will the geopolitical hotspots across the globe ignite further conflict?* Despite inflation uncertainty, things appear moving toward stability.

- *What impacts will the growing alternatives universe of private equity and private debt have on investors?* With a shrinking supply of public equities, investors are increasingly turning to private markets, although manager selection will be of paramount importance.

[1]YTD return numbers are from yCharts as of 12/06/2024. Equities are proxied by the ACWI ETF and bonds are proxied by the AGG ETF. All forecasts are expressions of opinion and subject to change without notice and are not intended to be a guarantee of future events. Past results do not guarantee future results. Real results may vary. [2]Mag7 includes AAPL, NVDA, MSFT, AMZN, GOOG, META, and TSLA

2024 Market Review

"2024 built on the strong performance of financial markets in 2023. Global equities are up 22.0% YTD, led by the US at +29.1%."

2024 extended the strong market performance of 2023. Global equities are up 22.0% YTD, led by the US at +29.1%. Returns in other regions are more muted with Europe at +6.7% and Asia at +6.1%. Growth continues to outperform as growth stocks are +36.7% vs value +20.2% YTD. Small cap stocks lagged for much of the year but have caught up in the past few months to be +20.1% YTD. Divergence across sectors was large with sectors such as financials and utilities up +35.6% and +28.7% YTD while healthcare lagged at +7.0%.[3]

Fixed income posted another solid year in 2024 at +3.5% YTD. Credit at +9.1% outperformed duration at -1.0% as risk assets did well and rates moved slightly higher. Emerging market bonds at +8.7% also performed well.[4]

Broad-based commodity indices were mostly unchanged on the year at -0.6%. This didn't stop strong performances from MLPs at +47.5% YTD and gold at +27.1% YTD.[5]

Asset Class	Ticker	YTD 2024	2023	'08-'22 Ann	Asset Class	Ticker	YTD 2024	2023	'08-'22 Ann
Short Municipal Bonds	SHM	1.99%	2.92%	1.90%	MSCI All Country All World	ACWI	22.00%	22.30%	6.36%
Long Municipal Bonds	MUB	2.91%	5.56%	3.41%	US Large Cap (S&P 500)	SPY	29.09%	26.19%	9.02%
US Aggregate Fixed Income	AGG	3.51%	5.65%	3.09%	US Small Cap (Russell 2000)	IWM	20.09%	16.84%	7.08%
Short US Treasury Bonds (1-3y)	SHY	3.88%	4.16%	1.33%	US Value Equities (R1000 Value)	IWD	20.21%	11.36%	6.89%
Intermediate US Treasury Bonds (7-10y)	IEF	2.06%	3.64%	3.66%	US Growth Equities (R1000 Growth)	IWF	36.69%	42.60%	10.87%
Long US Treasury Bonds (20y+)	TLT	-1.02%	2.77%	4.80%	Canadian Equities	EWC	18.01%	14.75%	3.02%
US Investment Grade Bonds	LQD	4.13%	9.40%	4.75%	European Equities (FTSE Europe)	VGK	6.64%	20.21%	2.39%
US Treasury Inflation Linked Bonds	TIP	3.67%	3.81%	3.76%	Pacific Equities (FTSE Pacific)	VPL	6.12%	15.58%	2.27%
US High Yield Bonds	HYG	9.11%	11.53%	4.56%	Emerging Market Equities (MSCI EM)	VWO	13.73%	9.27%	0.85%
Convertible Bonds	CWB	15.15%	14.49%	15.05%	Consumer Discretionary	XLY	31.02%	39.64%	11.88%
USD EM Bonds (JPM)	EMB	8.75%	10.60%	4.09%	Consumer Staples	XLP	16.68%	-0.83%	10.44%
Alerian MLP Index	MLPX	47.46%	15.73%	7.00%	Financials	XLF	35.56%	12.02%	3.24%
US REITs (MSCI REITs)	VNQ	11.42%	11.79%	6.14%	Health Care	XLV	6.99%	2.06%	12.98%
Commodities	DBC	-0.59%	-6.22%	-0.53%	Industrials	XLI	24.51%	18.13%	8.73%
Gold	GLD	27.09%	12.69%	6.97%	Materials	XLB	8.82%	12.46%	6.96%
Energy	XLE	11.20%	-0.64%	4.30%	Technology	XLK	25.78%	56.02%	12.98%
Agriculture	DBA	31.39%	7.63%	-1.71%	Utilities	XLU	28.74%	-7.17%	7.35%

Source: yCharts.com all YTD 2024 numbers are as of 12/06/2024

[3]YTD return numbers are from yCharts as of 12/06/2024. Equities are proxied by the ACWI ETF. US Equities are proxied by the SPY ETF. Europe equities are proxied by the VGK ETF. Asia equities are proxied by the VPL ETF. Growth stocks are proxied by the IWF ETF. Value stocks are proxied by the IWD ETF. Small cap stocks are proxied by the IWM ETF. Financial stocks are proxied by the XLF ETF. Utilities stocks are proxied by the XLU ETF. Health care stocks are proxied by the XLV ETF.
[4]YTD return numbers are from yCharts as of 12/06/2024. Fixed income is proxied by the AGG ETF. Credit is proxied by the HYG ETF. Duration is proxied by the TLT ETF. EM bonds are proxied by the EMB ETF.
[5]YTD return numbers are from yCharts as of 12/06/2024. Commodities are proxied by the DBC ETF. MLPs are proxied by the MLPX ETF. Gold is proxied by the GLD ETF.
All forecasts are expressions of opinion and subject to change without notice and are not intended to be a guarantee of future events. Past results do not guarantee future results. Real results may vary. The market returns presented herein are gross of fees and do not account for any management fees, advisory fees, trading costs, or other expenses that may be incurred in the management of an investment portfolio. As a result, the actual returns experienced by an investor will be lower than the gross returns presented. Investors should consider the impact of fees and expenses on their investment returns and consult with their financial advisor.

“...the market turned out to be right (and we were wrong) as inflation did come down, we avoided a recession, and higher rates did not have adverse consequences...”

How were our predictions?

In our 2024 Outlook written back in December 2023, we made the following predictions about 2024:

“As we see it, the market is putting a lot of weight on the narrow scenario of 1) inflation coming down, 2) avoiding a recession, 3) AI growing into the hype, 4) the delayed effects of higher rates not materializing, 5) geopolitical tensions staying contained.” The market turned out to be right (and we were wrong) as inflation did come down, we avoided a recession, and higher rates didn’t have delayed adverse consequences. The jury is still out on AI and geopolitical tensions remaining contained (more on both later) but at least for 2024 they weren’t factors limiting asset prices.

“Inflation is unlikely to come down to the extent the market believes absent a recession, making rate cuts without a recession less likely than the market believes.” We were right about inflation not coming down as much as priced – 1yr inflation was priced at just over 2% and now sits at 2.7% - but we were wrong suggesting the Federal Reserve wouldn’t cut without significant weakness. The Federal Reserve was expected to cut to 4.3% by the end of 2024 and, assuming the Fed cuts in December, Fed Funds will end the year at 4.5%. This easier policy was a factor supporting market prices in 2024.

“While the world will see many elections in 2024, we don’t believe they will have a profound impact on markets, although geopolitical tensions are likely to remain high.” We were correct on this to date, but will write about some potential impacts to markets in 2025 in what follows.

Big picture

In the years following the Great Financial Crisis, we were in an economic paradigm characterized by lower-than-expected growth and inflation, which enabled global central banks to stimulate the economy through low interest rates. Following the COVID-19 pandemic, governments responded with fiscal stimulus as well, injecting large amounts of money directly into the economy and into the hands of consumers. As the world began to normalize, consumers flush with cash from government stimulus spent money at record levels, while at the same time supply chains were heavily strained. In addition, the commodities markets were upended following Russia’s invasion of Ukraine. These dynamics ultimately led to the highest levels of inflation in 40 years and resulted in central banks aggressively raising interest rates to slow demand and reduce pricing pressure.

Higher rates flowed through the economy with long and variable lags, and, while global growth slowed, it did so in a surprisingly measured fashion while inflation returned close to normal levels. During the current cycle, several forces have buoyed economic growth including large capital investments in AI and stronger than expected consumer spending. Those large investments in AI also masked the slowing real economy with strong equity performance, although that performance was largely concentrated in a small number of companies benefiting from the increased AI spending.

Labor markets that were extremely robust in 2023 started to weaken slightly in 2024, and central banks have responded by lowering interest rates in Europe, Canada, and most recently in the US. Additionally, China has announced large stimulus programs. Normally, lower rates with moderate growth and inflation is positive for financial assets, but bond markets are currently pricing in continued interest rate cuts. Equity markets are simultaneously pricing in strong earnings growth. Together, these market expectations point to a perfect landing where the Fed moves back to a neutral base rate and equity markets benefit. The question going forward is whether reality will deliver on those rosy expectations.

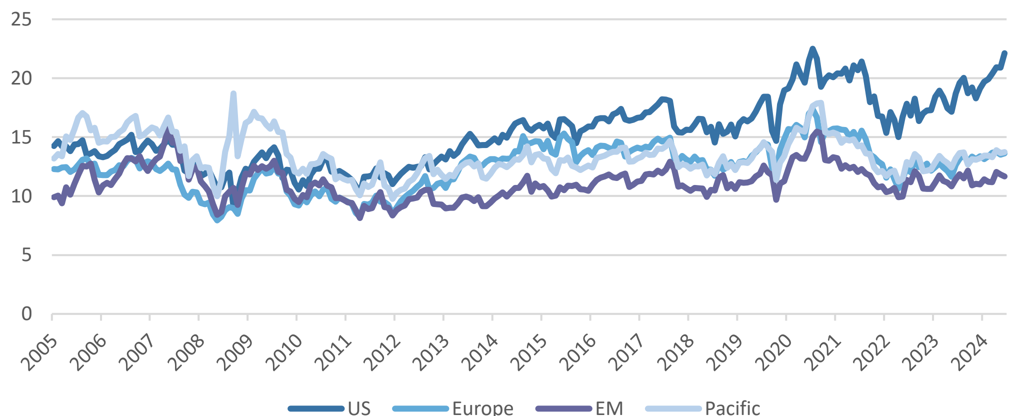
There are several important market dynamics currently underway, which are worth examining in more detail. First, Republicans swept all branches of government in the 2024 US election. This may embolden them to pass more aggressive policy measures, pressuring both inflation and debt levels. Second, AI has driven increased market concentration in the US to levels which historically have been unsustainable, increasing risks to client portfolios. Third, geopolitics have continued to take center stage among investors concerns. Lastly, there have been dramatic shifts in investment capital towards private markets, which will have consequences well beyond their respective markets.

2025 Market Pricing

Markets expect 75bps of easing from current levels through 2025… S&P500 forward P/E is at 22 primarily due to the Mag7 forward P/E being 35 although valuations outside of the Mag7 are much closer to long-term historical averages…

We always start our analysis of markets by looking at current pricing. Fixed income markets shifted to meaningfully higher rates since the early fall when Fed Funds rates for December 2025 were expected to be as low as 3%. Currently, Fed Funds for December imply an additional 75bps of easing from current levels. Inflation rates are expected to be 2.5% over the next 2 years and 2.4% over the next 5 years versus the last reading of 2.6%. We have been, and still are, in the camp that a gradual easing of policy rates of 75bps over 12 months is far less likely than maintaining current rates or, in the event of a recession, a much larger move down.

The S&P 500 forward P/E ratio is around 22, which is very elevated relative to history. Much of the elevated valuation of equities at the index level can be attributed to the largest constituents of the index, known as the Magnificent 7 ("Mag7": Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, and Tesla). The Mag7 have an average forward P/E of 35 if you exclude Tesla's P/E of 144. Both revenue and earnings growth of the Mag7 is expected to be near 20% in 2025. Mid and small-cap stocks and markets outside of the US are trading at much more reasonable valuations near their historical average of 15-16.



Source: Bloomberg, data from 06/30/2005 to 11/29/2024

Forward P/E ratios, a measure of the price-to-earnings ratio using forecasted earnings, can vary significantly across different regions. These ratios provide a snapshot of how different markets are valued based on expected future earnings.

US Policy

Following the 2024 US elections, there are several key components of the incoming Administration's economic agenda that are worth exploring.

Tariffs

Tariffs are a key component of the incoming Administration's agenda for two reasons. First, tariffs represent a potential source of revenue which could offset some of the potential deficit implications of extending the 2017 Tax Cuts and Jobs Act. Second, policy makers, including President-elect Trump, view tariffs as a negotiating tool to help achieve other goals.

"...In our view, future tariff policy is likely to consist of strong rhetoric followed by more subdued policy action...

... the incoming administration cannot undertake policies that would push rates substantially higher from here as we believe it would create widespread issues..."

In our view, future tariff policy is likely to consist of strong rhetoric followed by more subdued policy action. We have already seen evidence of this. Recently, incoming President Trump posted on social media calling for a 25% tariff on all products from Mexico and Canada. If implemented, the consequences are likely to be felt by key constituents within the President's current base of supporters, given that Mexico produces cars for some of the biggest auto manufacturers in the United States. From January to July of 2024, General Motors and Ford were the largest exporters of light vehicles from Mexico to North America, and over 90% of these vehicles went to the United States.[6] In other words, these tariffs are unlikely to be implemented, and in our view are designed to bring policymakers from Mexico and Canada to the negotiating table.

Deficits

When incoming President Trump was inaugurated in 2017, the budget deficit was just over 3% of GDP, and interest rates were still historically low in response to the modest recovery following the great financial crisis. Today, the deficit is over 6% of GDP and is projected to rise towards 10% over the next several decades.

Heading into the election, candidate Trump's policies were viewed by both economists and the market as more likely to widen the budget deficit. In the weeks leading up to the election and immediately thereafter, yields on long-term US Treasuries rose over 0.5%. That said, we believe the incoming administration cannot undertake policies that would push rates substantially higher from here as it would create widespread issues. It could also put stress on the equity market which is his ultimate barometer of success. President Trump and his policy team understand this and, in our opinion, will likely talk rates down. Separately, we would anticipate increased demand by insurance companies and pensions as rates approach 5%, further limiting the potential upside of higher rates.

Scott Bessent's nomination as Treasury secretary was the first signal to markets that the Administration respects the deficit as a political issue. Bessent has publicly stated that his goal is to reduce the deficit back down to 3%, which will almost certainly require interest rates to come down over time, given that net interest outlays are the primary factor contributing to the widening deficit. Other ancillary measures such as cutting spending through the newly created Department of Government Efficiency (DOGE), are unlikely to have a meaningful impact due to their relative contributions.

[6]https://www.reuters.com/business/autos-transportation/gm-other-us-automakers-would-take-big-hit-trump-tariffs-2024-11-26/

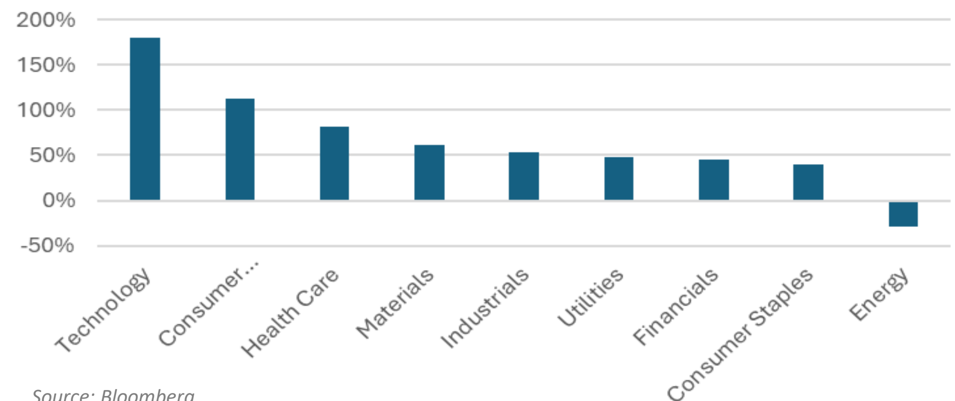
“… There are a few obvious sectors that stand to benefit from the incoming Administration’s deregulatory stance including financial services, energy and transportation…”

Deregulation

During President Trump’s first term, he made deregulation a priority. According to the Brookings Institute, a nonprofit public policy organization, the primary triumph of President Trump’s deregulatory agenda was significantly reducing the number of new regulations compared with this two previous predecessors. President Trump’s first administration added just $10B in new regulatory costs compared with $111B for President Barack Obama and $43B for President George W. Bush.[7]

There are a few obvious sectors that stand to benefit from the incoming Administration’s deregulatory stance including financial services, energy, and transportation. That said, there is not a clear relationship between the stated goals of the administration and sector returns. During President Trump’s first term, two of the three worst performing sectors in the S&P 500 were financials and energy, highlighting the difficulties in predicting sector level returns.

S&P Sector ETF Returns During President Trump’s 1st Term



Source: Bloomberg

The information presented in this chart is for informational purposes only. The data reflects historical performance of S&P 500 sectors from January 20, 2017 until January 20, 2021 and is not indicative of future results. Investors should consider their own financial situation. Past performance is not a guarantee of future returns. The chart includes gross returns from various ETFs that track the S&P 500 sectors, and the returns are subject to market risks and fluctuations. The returns shown are gross returns, which do not account for fees, expenses, or taxes that may affect the actual returns an investor receives.

Artificial Intelligence

“We are suffering, not from the rheumatics of old age, but from the growing-pains of over-rapid changes, from the painfulness of readjustment between one economic period and another. The increase of technical efficiency has been taking place faster than we can deal with the problem of labour absorption; the improvement in the standard of life has been a little too quick…” This statement was made in a paper *The Economic Possibilities for our Grandchildren*. The shocking part is it was made in 1930 by John Maynard Keynes. Keynes’ fear was about automobiles and television sets. Almost 100 years later, the fear of technological change now focuses on Artificial Intelligence (AI) and what it may do to jobs and society at large.

[7]https://www.brookings.edu/articles/examining-some-of-trumps-deregulation-efforts-lessons-from-the-brookings-regulatory-tracker/

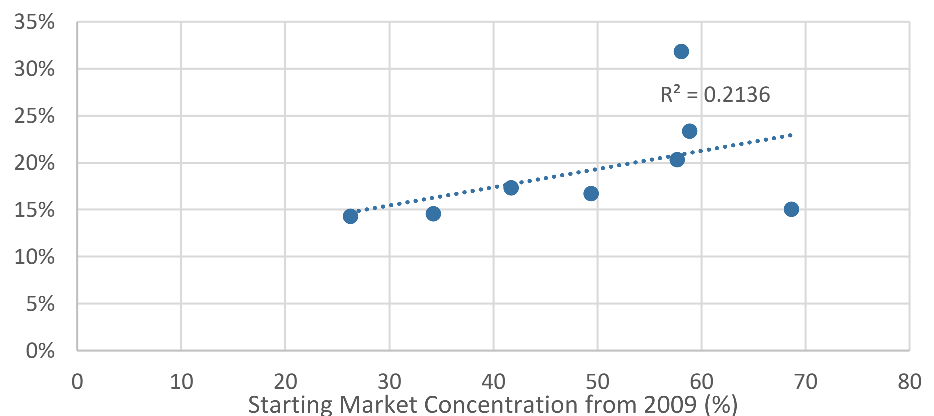
> "...Similar to the early days of the internet, the greatest use cases of AI might not even be known yet. Along the same lines, the impact on society is a topic of great concern..."

AI's potential to boost productivity is significant, and we at GenTrust are firm believers in its long-term power. We have been using data analysis and simplified non-learning versions of AI to aide in our trading analysis and portfolio management for years. We have also been looking for other ways we can use AI to help better serve our clients and are very excited about the possibilities. AI will impact just about every industry from manufacturing to services to healthcare. Similar to the early days of the internet, the greatest use cases of AI might not even be known yet. Along the same lines, the impact on society is a topic of great concern.

Market Concentration

One of the negative consequences of the boom in AI is that global equity markets have become considerably more concentrated over the last 15 years. In 2009, the 10 largest constituents of the ACWI were just 6.7% of the index. Today, the top 10 names are 22.7%. A lot of attention has been paid to the market concentration in the United States, where the top 10 constituents in the S&P 500 have grown their market share of the index by over 65%.[8] Market concentration creates two issues. First, there is a limit to how big any small set of companies will be allowed to get before a whole set of constraints ranging from anti-trust to more nimble competition start to impinge on growth. It's hard to know where that upper bound is, but it's there and we believe markets have been getting closer to it. Second, a more concentrated market reduces an investor's ability to diversify, likely amplifying risk in the form of increased volatility. As shown in the plot below, there is some correlation between market concentration and volatility.

Starting Market Concentration vs. Realized Volatility



Source: Bloomberg, data from 2009 to 2024

Market Concentration: This is typically measured as the percentage share of the market held by the top few firms. Realized Volatility: Refers to the historical volatility, often measured as the standard deviation of returns over a certain period. It quantifies how much asset prices have fluctuated in the past. $R^2 = 0.2136$ means the variability in the realized volatility is explained by the changes in market concentration.

[8] https://www.aspeninstitute.org/wp-content/uploads/files/content/upload/Intro_and_Section_I.pdf

“...The expected revenue growth of the Mag7 group in 2025 is 20%... and the expected EPS growth is 20%...”

Many have highlighted that the AI boom will likely come in various phases, the first being the “picks and shovels” where the firms selling the basic infrastructure needed for AI such as NVIDIA will benefit. The next phase is AI infrastructure such as cloud providers and data center REITs. The third phase would include software and IT services firms that can monetize AI. The Mag7 stocks (MSFT, META, AMZN, AAPL, TSLA, GOOG, NVDA) are clearly in the first few phases and have already benefited, finishing up over 100% on average in 2023 and up over 60% on average in 2024 as a group. Collectively they now represent nearly 1/3 of the S&P 500.

The Mag7 are expensive on traditional valuation metrics, although their profit margin differential and enormous cash balances explain much of the valuation premium they have over the rest of the S&P 500. When looking at analyst revenue and EPS growth estimates for the next year, compared to the previous 5 years, a few things stick out:

- The expected revenue growth in 2025 of the entire group is 20%, led by NVDA at 52% and the others at 11-18% except AAPL at 7%
- Similarly, the expected EPS growth of the entire group for next year is 20%, led by NVDA at 46%, TSLA at 35% and others are 11-13%

Ticker	Name	Market Cap (bn)	Total Return YTD	Fwd Price/Sales	Fwd Price/Earnings	Previous 5y Revenue Growth	Next Year Revenue Growth	Previous 5y EPS Growth	Next Year EPS Growth
AAPL	Apple Inc	$3,671	27	8.9	32.9	8.1%	7.0%	16.9%	10.5%
NVDA	NVIDIA Corp	$3,488	188	27.5	49.1	63.5%	52.3%	82.6%	46.5%
MSFT	Microsoft Corp	$3,298	19	11.7	33.5	14.2%	13.4%	18.0%	11.7%
AMZN	Amazon.com Inc	$2,387	49	3.6	42.6	17.9%	10.8%	40.7%	12.6%
GOOG	Alphabet Inc	$2,160	26	6.2	22.1	17.5%	17.9%	23.3%	11.6%
META	Meta Platforms Inc	$1,575	77	9.5	27.1	18.2%	14.7%	18.9%	12.4%
TSLA	Tesla Inc	$1,249	57	11.5	144.4	32.3%	16.7%	34.2%	35.4%
Average		**$2,518**	**66**	**12.2**	**43.5**	**25.1%**	**20.2%**	**35.3%**	**20.1%**

Source: yCharts.com as of 12/06/2024

Part of the great outperformance of the Magnificent 7 over the past decade is that the extraordinary growth they delivered was not priced in—and there is good reason for this. Research from Goldman Sachs found that, going back to 1985, only 11% of companies in the S&P 500 that achieved 10% sales growth in one year were able to maintain this growth rate for a full decade. For companies that achieved 20% sales growth, only 3% of them were able to continue to deliver that sales growth for a full decade. Now that these companies have delivered such astounding growth, they are priced for this to continue, which would certainly defy the historical odds.

Geopolitics

The increasing global conflicts are leading to risks in inflation and financial market stability. From the 1990s to the 2010s, globalization was a significant factor in maintaining low and steady inflation. However, with increases in conflict comes the risk of decreased global trade, increased reshoring, and higher input costs for many goods and services.

The United States is still heavily dependent on China as an input for many supply chains. The increased conflict over Taiwan and the semiconductor industry has led many US based companies to begin moving their supply chains back to the US or to other countries in Southeast Asia. Additionally, the US Dollar's status as a reserve currency is now under threat by China, who is aiming to create a replacement reserve currency with other Emerging Market nations. While this process may take many years or even decades to fully play out, it could undermine US supremacy and the ability to manage the growing US national debt.

Chinese economic conditions were subdued this year with the ongoing slowdown in the property sector. China's central bank cut the reserve requirement ratio and repo rates in September and various loan rates in October. The government also announced $1.4trn of stimulus spread over 5 years to help the consumer. Despite being 1.5% of GDP per year, economists believe this will help growth by as little as 0.4% in 2025 and the effects on neighboring economies to be negligible.[9] China observers expect the government to offer more stimulus if the US were to raise tariffs on China under the new administration early in 2025.

The conflict between Russia and Ukraine is almost 3 years old. With Russia currently occupying about 20% of Ukraine, there is some tacit acknowledgment from the Ukrainian President Zelenskyy that the war is unwinnable. He has indicated he is willing to "fight" for the lost land diplomatically rather than militarily going forward, provided that the free part of Ukraine can move under the NATO umbrella. Russian President Putin appears amenable to stop fighting if he can keep what he won, and not have NATO on its border. President-elect Trump is less likely to keep giving money and weapons to Ukraine and is also unlikely to admit Ukraine into NATO. Within this configuration of interests, perhaps there is a solution to stop the war, and freeze the conflict.

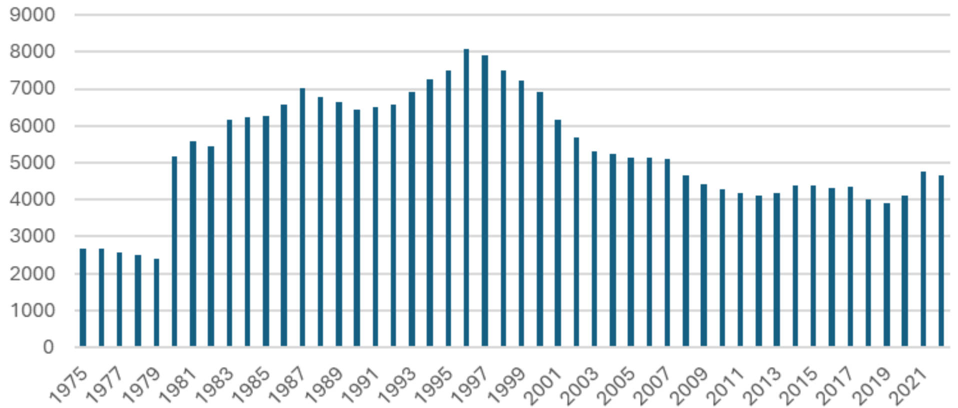
The World Bank estimates that the reconstruction of Ukraine will cost about $500bn. Let us assume that it is $500bn and countries that donate require that money given be spent to benefit their own economies over several years, this will amount to a very small economic positive for all contributors (roughly 0.2% per year of GDP). Of greater importance is the likely resumption of the energy trade with Russia and the grain trade with Ukraine. This could make German industry competitive again and allow it to recover from its current slump by reducing food prices from current levels. All of this is a positive, not to speak of putting a stop to the loss of life.

[9]Source:https://www.cnbc.com/2024/11/08/china-expected-to-announce-highly-anticipated-fiscal-stimulus-package.html#:~:text=China%20on%20Friday%20announced%20a,for%20more%20direct%20fiscal%20support.

Private Assets

Shrinking Stock of Public Equities

Over the past several decades, the number of publicly available companies has declined, which presents unique challenges for investors. Beginning in the 1980s, the number of publicly traded companies increased steadily, and reached a peak during the dot-com boom at around 8,000 companies. Today, the number of publicly available companies is less than 5,000, which is below the level in 1980.



Source: World Bank

“…the growth of venture capital, private equity and private credit are the driving force behind the dearth of IPOs… the decline in IPOs has reduced the quality of the small cap space… the growth of private markets has asset allocation implications…”

While there are several factors that have contributed to this phenomenon, the tremendous growth of venture capital, private equity, and private credit are the driving force behind the dearth of IPOs. Becoming a publicly traded company is much more onerous than remaining private, and given how developed the private markets have become, companies are choosing to stay private for longer or exit through other mechanisms such as a merger or acquisition.

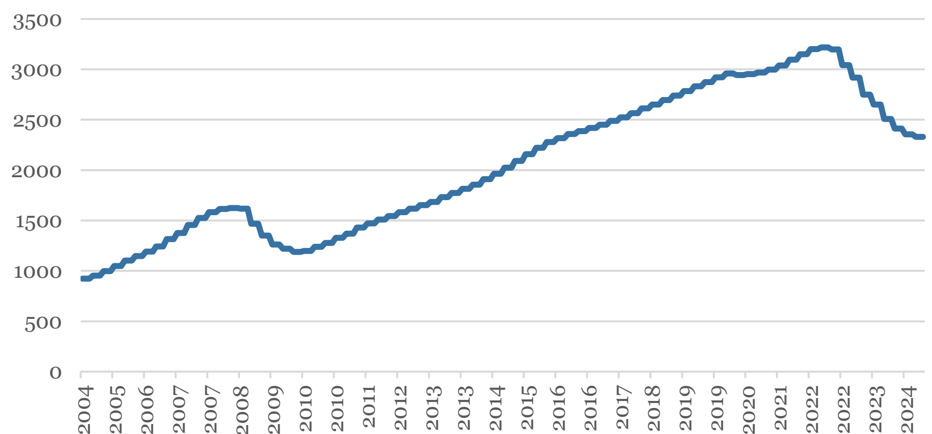
There are several consequences to this. First, all else equal, a decline in the number of publicly available companies will increase market concentration in market cap weighted indices, which is currently at extreme levels relative to history. Second, the decline in IPOs has reduced the quality of publicly available companies—particularly in the small cap space. High quality small and mid-cap companies, defined as profitable business with stable and predictable earnings, have ample access to private capital given the growth of the private equity and venture capital industries. As a result, small and mid-cap companies going public today are often going public because they are not of high enough quality to access private capital. This has unfortunately led to underperformance in small and mid cap public stocks. The most striking example of this was during the SPAC craze several years ago, where dozens of unprofitable companies went public through special purpose acquisition vehicles, only to deliver poor returns to shareholders as public companies. Lastly, the growth of the private markets has asset allocation implications, as it may make sense for investors to explore these asset classes to achieve greater diversification. In the rest of this section, we walk through our thinking on various private asset classes including commercial real estate, private equity, and private credit.

Commercial Real Estate

The commercial real estate ("CRE") market is down roughly 20% peak-to-trough (NCREIF Index, Cambridge Outlook 2025) as interest rates rose 3%-4% from 2022 to 2023. Delinquency rates for CRE loans jumped to 11% at the large banks in the second quarter of 2024.[10] Overall CRE has taken a one-two punch from capital markets and decreasing demand (i.e. office), but so far has escaped the knockout punch of a recession. Hopes of lower interest rates have stabilized the market temporarily but CRE funds itself mainly in the 5-7 year portion of the interest rate curve, which was less affected than the shorter end. Estimates show that more than $2.2tn of CRE debt needs to be refinanced before 2027.[11] In addition to these high-level sector issues, there are also sub-sector specific dynamics to navigate.

"...CRE market is down roughly 20% peak-to-trough as Fed Funds as interest rates rose 3-4%... Estimates show that more than $2.2tn of CRE debt needs to be refinanced before 2027... In addition, some sectors such as office face shifting demand needs..."

Office continues to have the most acute issues, dealing with both higher interest rates and shifting demand. Post-pandemic, there has been a renewed effort to get employees back to the office, but that push seems to have less impact going forward, as most of the companies that will return to offices have already done so. This oversupply appears here to stay and has led to some eye-opening office sales, such as The Gas Company Tower in LA, which is slated to sell for ~$200mm after being appraised at $632mm just a few years ago. We expect office CRE to continue to be stressed in 2025.[12] Industrial has been the golden child of the CRE market throughout the post-COVID pandemic era. Whether it has been distribution centers for online shopping, or new manufacturing from companies on-shoring, the industrial sub-sector has outperformed. New supply in recent years is leading to a more balanced market, and we would expect continued outperformance in 2025. In multi-family ("MF"), there were supply-demand imbalances created by COVID-19. A massive wave of rental demand hit the market in early 2021, which led developers to start projects for MF housing. These new projects hit the market just as renter demand was decreasing post-pandemic. This led to an oversupply and regional stagnation of rent increases. As this supply is slowly worked through, we expect MF owners to once again be able to "push" rents.



Source: Bloomberg

[10]https://www.bloomberg.com/news/articles/2024-11-15/banks-raise-capital-to-brace-for-continued-cre-losses-fed-says
[11]https://www.wsj.com/real-estate/commercial/the-bill-is-coming-due-on-a-record-amount-of-commercial-real-estate-debt-451ec8cb
[12]https://la.urbanize.city/post/la-county-votes-purchase-gas-company-tower

“...In the last year, public markets outperformed PE by almost 14%, driven by a lack of exits in the upper market PE space... Entering 2025 we think the middle market of private credit looks more attractive but manager and sub-sector selection is of paramount importance...”

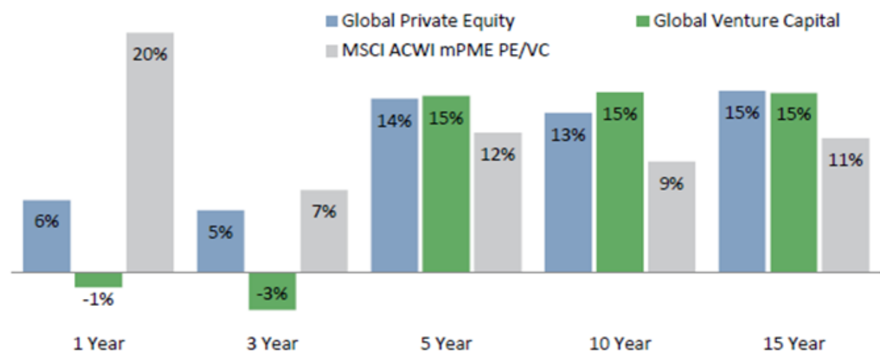
PE in the New World

Private equity (“PE”) has been a staple for institutional investors over the past 25 years. Historically private equity tends to outperform the broader public markets, which makes complete sense given the worse tax implications of PE versus a buy-and-hold public market strategy, and the illiquidity premium of PE investments. In the last year, public markets outperformed PE by almost 14%, driven by a lack of exits in the upper market PE space.[13] Many PE funds that deployed capital in 2020 and 2021 during the Zero Interest Rate Policy environment had overvalued prices. Exiting those positions at a profit has been a challenge for the PE space. Moving into 2025 we believe M&A activity will pick up and some of these older vintages will begin to return money to investors. As deal activity picks up, we would expect dry powder to be deployed. Most of this dry powder resides in the upper market and with larger managers.

Valuations in PE have also come down, mostly in the middle market. The median US PE buyout multiple has come down from 11.9x in 2022 to 10.4x for the first 6 months of 2024 (Preqin data). For 2025 this should be a decent backdrop for middle market PE.

Private Credit

Private credit has been one of the fastest-growing segments of the financial system of the past 15 years. Banks have pulled back from the market as rate increases left them with poor capital buffers. The private credit market has surpassed $2tn, and many market prognosticators think the market can grow 10x+ by 2030. This rapid growth is almost always cause for concern, but fundamentals remain strong. Spreads have continued to tighten in the direct lending market but remain well above public market debt. Most of the capital raised in this sector targets the upper market, which tends to compete with broadly syndicated loans. The competition in this upper market could lead to less covenants and increased susceptibility to economic downturns. Entering 2025, we think the middle market of private credit looks more attractive but manager and sub-sector selection is of paramount importance.



[13]Source: Cambridge Outlook

Crypto

Cryptocurrencies have rallied significantly since the U.S. elections in November. Bitcoin's market price has risen from ~$68k pre-election to ~$100k as of the writing of this outlook. Crypto ownership's five-year compound annual growth rate is 99%! (Cambridge 2025 Outlook) There are two main viewpoints on fundamental value for most cryptocurrencies; 1) a store of value, 2) a means of exchanging value. Both of these viewpoints are more theoretical than practical at this stage, as crypto has largely been uncorrelated to other stores of value such as gold, and a means of exchange has not developed. Recent progress in quantum computing could also threaten the very technology that bitcoin is built on. Therefore, the primary price driver of crypto at this point is speculation. This can be seen by the proliferation of levered plays on crypto such as Microstrategy and the various levered forms of owning that stock, which in turn just own more Bitcoin. This leverage is worrisome and should lead holders of crypto to be concerned about an overallocation to the asset class.

Summary

2024 was a great year for financial assets. For 2025, market pricing implies that the Federal Reserve will cut rates by another 75bps. Inflation is priced to remain around its current levels of 2.6% in 2025, and S&P 500 earnings are expected to grow by 13%. Valuations are rich, as SPX is at a forward PE of over 22, driven by Mag7 stocks with a P/E over 30, a challenge investors are facing by increasing allocations to private markets. We view future tariff policy will likely consist of strong rhetoric followed by more subdued policy action, budget deficits will not be as big of an issue as markets are concerned about, and deregulation will be a positive for markets but maybe not in the manner you would forecast.

From a positioning perspective, we are overweight fixed income and neutral other asset classes. We have very moderate amounts of tilts in portfolios, preferring to stay nimble and react to the changing landscape.

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