First Citizens Wealth™ | Making Sense

Basis Points | February 12, 2025

Balance of Risk

1. Competing Narratives

Financial markets are tracking two dissonant themes: strong economic fundamentals and elevated uncertainty. **On one side, the US economy continues to showcase its strength.** GDP rose 2.8% in 2024, and in each of the last eight quarters the economy has grown at a rate faster than the estimated "potential growth" speed limit.[1] In addition, with job growth solid and unemployment hovering around 4%, the labor market no longer appears worrisome like it did last summer, spooking markets and prompting the Fed to slash rates. **But on the other side of the screen, uncertainty abounds.** Inflation is still a problem, equity valuations are stretched, and the market overall appears priced for good news. On top of all this, firms globally are navigating a highly uncertain outlook for tariffs and international trade that could deliver a wide range of economic and market outcomes.

2. Constructive but Cautious

While we remain constructive on US equities, our price target of 6,400 is below the top-down consensus.[2] We do not expect stocks to rise in a straight line this year as elevated uncertainty may lay the groundwork for market volatility. Periodic drawdowns are standard fare, and we would not be surprised to see a selloff this year that surpasses last summer's 9% decline. **But rather than trying to time stock markets, we think the better play is to pursue diversification and balance in portfolios.** With bonds now yielding 4.9%, fixed income is offering attractive yield, typically a good indicator of fixed income total return.[3] The recent resurgence in yield may seem unusual given the Federal Reserve's recent rate cuts, but history shows that when the Fed cuts rates as a mid-cycle adjustment rather than a recession response, yields typically end up higher, not lower, after several months.

3. Tariff Talk

President Trump has proposed the steepest tariffs on US imports in decades, and markets have taken notice. So far, the market reaction may seem mild compared to the 2018-19 experience, when equity markets sold off an average of 1% around new tariff announcements, which affected a smaller share of imports and imposed a lower duty rate compared to today's proposals.[4] So, are markets more sanguine about tariffs this time around? Not necessarily, for a few reasons: First, policies have changed rapidly, including intraday. Second, rightly or wrongly many investors view today's tariff proposals largely as a negotiating tactic. Third, the new Administration is only in its fourth week. Fourth, there is little consensus today around how tariffs will affect price levels, inflation, profit margins, and supply chains. **We see trade policy as a source of significant uncertainty but not one that necessarily crowds out other market fundamentals.**

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4. (Im)balance of Risk

Economists and policymakers often frame the economic narrative around the so-called "balance of risks" to inflation and employment. Six months ago, the consensus narrative was that risks were skewed toward the downside for the labor market while risks to inflation were broadly balanced.[5] As a result, the Federal Reserve (aggressively) eased monetary policy in order to loosen financial conditions and hopefully support the labor market, lowering the overnight policy rate by 100 basis points in three months. **Since then, the balance of risks may have reversed: risks to the labor market appear roughly balanced, but risks to inflation appear tilted back to the upside.** This morning's CPI inflation report showed core (ex- food and energy) inflation reaccelerating to 3.3% against market expectations for a slowdown to 3.1%. One month does not make a trend, but markets reacted forcefully, with 10-year yields climbing 10 basis points to 4.64% after one hour. Expectations for Fed policy also changed somewhat: the futures market pushed back its expectation for the next 0.25% rate cut to December 2025 (from September). But also interesting is the market's expectation for "breakeven" inflation rates over the next five years, which at 2.7% have now climbed to the highest level in almost two years, potentially indicating a view that policymakers are willing to tolerate inflation above 2% for the medium term.

[1] The Federal Reserve estimates the long-term potential growth rate consistent with population trends, productivity trends, and stable inflation is 1.8%.

[2] Next twelve months.

[3] Bloomberg USAgg Index, a broad-based benchmark that measures investment grade taxable US bonds.

[4] Amiti, Gomez, Kong, and Weinstein (2025) "Trade Protection, Stock-Market Returns, and Welfare." National Bureau of Economic Research Working Paper 28758.

[5] See: Federal Reserve, Summary of Economic Projections for September 18, 2024, Figures 4.B. and 4.C. "Uncertainty and risks in projections."