2025 OUTLOOK

FINDING BALANCE:
FISCAL ADVENTURES VERSUS THE BOND MARKET

TIAA Wealth Management

CIO PERSPECTIVES

Executive Summary

- During 2024, many of the distorting impacts from the pandemic years began to normalize. The U.S. economy exhibited more organic growth driven by an improvement in private sector consumption, by the moderation of inflation toward long-term historical levels, by labor market supply and demand coming into better balance, and by corporate earnings growing at a steady rate after two flat years. The stock market reacted in kind, with the S&P 500 higher by 28% (through December 2, 2024), up more than 20% for a second consecutive year. The bond market was volatile, but still provided 3% returns for the year.
- Our base case for how 2025 may develop includes a particular focus on four important themes:
    1. U.S. economic growth outperforms the rest of the world.
    2. Two-sided risk to inflation keeps bond volatility high.
    3. Fiscal policy drives shifting market and monetary policy outcomes.
    4. Global economic fragmentation accelerates.
- Additionally, the new administration's policy mix results in a balance of moderate tax cuts, deregulation, and targeted yet not indiscriminate tariffs. As a result, income and spending growth slow only marginally from above-trend levels, in line with cooler but still healthy labor market conditions. The targeted nature of trade tariffs limits their impact on consumer prices, and inflation stabilizes, albeit at levels slightly higher than 2%. In this scenario, the Federal Reserve (Fed) is able to continue normalizing monetary policy, supporting moderate gains in both equity and bond markets.
- Concerns over current U.S. fiscal policy have not resulted in a significant reaction from the bond market but have raised the prospects for higher bond yields. The new administration and Republican-controlled Congress will have to strike a balance between bigger deficit policies and keeping bond yields in check.
- Given elevated equity valuations, we believe returns will have to come from earnings going forward. In the same vein, given that investment grade and high yield spreads are near the tightest levels since 1998, our view is that fixed income returns will largely come from attractive coupon payments rather than price appreciation.
- The U.S. elections have ushered in a new paradigm for the economy, policy, and geopolitics, and the market narrative will be sensitive to what policies are prioritized by the new administration. This unusually complex environment requires investors to have a flexible approach, while staying invested and anchored to their long-term asset allocation as per their financial plan.
- Given the uncertainty related to how the economic fundamentals will respond to the evolving policy landscape, we will closely monitor ways in which current market consensus could be upended in 2025.

Table of contents

2025 OUTLOOK: FINDING BALANCE

What is the TIAA Wealth Chief Investment Office's outlook for 2025?

During 2024, many of the distorting impacts from the pandemic years began to normalize. The U.S. economy exhibited more organic growth driven by an improvement in private sector consumption, by the moderation of inflation toward long-term historical levels, by labor market supply and demand coming into better balance, and by corporate earnings growing at a steady rate after two flat years (which were preceded by the booming earnings growth of 2021). The stock market reacted in kind, with the S&P 500 higher by 28%, up more than 20% for a second consecutive year. The enthusiasm around artificial intelligence (AI) as a transformative technology was another catalyst powering large-cap secular growers forward. The bond market[1] was volatile, whipped around by shifting expectations for inflation and monetary policy, but still provided 3% returns for the year.

2024 was a landmark year in human history for elections, with roughly 70[2] countries going to the polls. Political uncertainty was the name of the game, and results were generally not favorable for incumbents—from the United Kingdom to France to India to America. In the second half of the 2020s, new governments coming to power will be navigating powerful economic and geopolitical issues, such as domestic polarization and income divides, rising government debt levels, proliferation of AI, climate change, and immigration related challenges—not to mention the hot wars, cold wars, technology wars and trade wars occurring around the world.

We are nearing the halfway point for this decade. We maintain our view that there is a lot to like about the U.S. economy in the long run—highlighted by accelerating innovation, new business formation, reshoring of supply chains, industrial policies toward infrastructure upgrades, high-end manufacturing facilities, and demographic tailwinds keeping a bid on housing and financial assets. For 2025 though, the Republican trifecta creates opportunities and risks for the economy and investors. On one hand, growth is still resilient, the Fed prefers to ease monetary policy, and optimism is increasing. On the other, the threat of tariffs looms, government financial obligations keep growing, and a segment of consumers is becoming exhausted due to inflationary pressures.

Below we highlight our base case for how 2025 could evolve.

1 | U.S. economic growth outperforms the rest of the world.

- The U.S. consumer and labor market remain resilient for now. However, the lagged impact of higher interest rates is still working its way through the economy and causes the demand for labor and consumer spending to moderate. Growth weakness is not imminent, but the risk is higher than average.
- Pro-growth domestic policies such as deregulation, less stringent antitrust enforcement, prospects for lower taxes and continued reshoring should boost business confidence and investments into manufacturing facilities and equipment, supporting productivity growth.
- European growth remains hobbled by loss of competitiveness and underperforming corporate earnings. Uncertainty surrounding U.S. tariff policy, a snap election in Germany, and a standoff with the U.S. on security issues hold back investor confidence.
- Pressure ramps up on Chinese authorities to support the economy in a more forceful fashion, amid a backdrop of lackluster consumer sentiment and spending and rising tensions with the U.S.

2 | Two-sided risk to inflation keeps bond volatility high.

- Moderation in services sector spending, slowing shelter inflation, and productivity growth all keep inflation on a stable, downward trajectory. But core inflation remains above the Fed's 2% target.
- However, medium-term inflation expectations remain elevated, given the potentially inflationary side effects of the Trump 2.0 agenda.
- Interest rates remain volatile to these expectations and sensitive to the need for higher Treasury issuance to fund future tax cuts and spending. In a non-recessionary scenario, the 10-year Treasury yield remains elevated, with a higher term premium.[3]

3 | Fiscal policy drives shifting market and monetary policy outcomes.

- Encouraged by the electoral win, Congress and the White House pursue their agenda for extending tax cuts, raising tariffs (or using the threat of it for trade negotiations), and curbing immigration (Figure 1). However, the Republican hold on the House is fairly tenuous, which could lead to a slow rollout of some legislative actions the market is counting on.
- Given the already weaker fiscal dynamics of higher deficits, debt and interest rates, there is a not insignificant risk that the bond market forces the new administration to adopt a more prudent approach to fiscal management and/or sequence their agenda to calm investor concerns.

- The Fed is biased toward cutting interest rates, focusing on the recent path of inflation and the labor market, rather than trying to preempt fiscal policy. However, the central bank remains data dependent and wary about easing too aggressively, given uncertainty about the level of the neutral rate.[4] They may choose to look past the potential for higher tariffs, as their impact on growth and persistent inflation is unclear, but will be attentive to the risk of inflation picking back up due to animal spirits—i.e., rising corporate, investor and consumer confidence.

FIGURE 1

President Trump's path to enacting key proposed policies outlined on the campaign trail.

Campaign Proposal	Executive Action Alone	Congressional Legislation Required	Likely Court Challenge
Tariffs			
Blanket tariffs on all imports to the U.S.	●		●
Tariffs imposed on grounds of national security or foreign trade malpractices	●		●
Fed Policy			
Demote or replace Jerome Powell*	●		●
Enact more presidential control over rates		●	●
Taxes			
Extend 2017 tax cuts		●	
Lower corporate tax rate from 21% to 15%		●	

* New Fed chair is subject to confirmation to the Senate.

Sources: Bloomberg News reporting, TIAA Wealth CIO.

4 | Global economic fragmentation accelerates.

- U.S. and China relationship comes under further stress due to the new administration's threat of higher tariffs, export controls for key technologies and the possibility of retaliatory tariffs. Investors struggle to price in the impact of tariffs on growth and inflation.
- U.S. tensions rise with allies in Europe over trade, Ukraine support and long-term security arrangements. However, internal disagreements over support for Ukraine, weakened French leadership, and a collapse in Germany's governing coalition creates challenges for a united response to increasingly hawkish U.S. demands.
- A growing need by non-U.S. economies to be more self-reliant and to lessen dependencies on foreign markets leads to increasing investments in domestic production, research, and defense capabilities across major economic blocs.

- Globalization continues to morph. In deciding their manufacturing and sourcing plans, companies pay as much attention to the risks around global shocks like the pandemic, supply chain disruptions and geopolitical upheaval, as to efficiency and cost savings.

Market Implications

The U.S. elections have ushered in a new paradigm for the economy, policy, and geopolitics. The market narrative will be sensitive to what policies are prioritized by the new administration. Volatility will be more prevalent as sentiment wavers between soft landing and no landing—or even a hard landing (recession) for the economy (see Figure 2 for scenarios). This unusually complex environment requires investors to have a flexible approach, while staying invested and anchored to their long-term asset allocation as per their financial plan.

Equities may continue to drift higher, supported by broadening corporate profits and market-friendly deregulations. However, given higher starting valuations, our expectation is for moderate returns going forward, compared to recent years. The recent strong momentum in equities has pulled forward some of the returns from 2025 and has yet to price in the uncertain impact of higher tariffs, immigration curbs, and the risk of higher interest rates.

We advocate for keeping a balance of Growth and Value exposures. Value can benefit from a 4% to 5% nominal growth environment, lighter regulations, and attractive relative valuations. Growth continues to see strong underlying trends from AI, cloud, data center investments, and the scarcity premium from lack of scalable businesses in this space.

Despite higher valuations, U.S. assets remain better positioned compared to developed international and emerging markets. The threat of higher tariffs can further hurt sentiment toward China and Europe, where economic activity and corporate earnings momentum have been lackluster to begin with. The U.S. dollar can remain elevated due to higher relative interest rates, continued U.S. exceptionalism, stronger productivity, and the growing innovation gap. However, we maintain the importance of having international exposure in long-term portfolios given their attractive valuations, diversification benefits and yield opportunities.

For fixed income, the prospects for large and growing budget deficits are likely to keep bond volatility elevated. Interest rates could rise further from current levels, providing opportunities to lock in higher yields during the year. Additionally, given the historically tight credit spreads, corporate bonds are likely to be a total yield rather than a spread story. Demand for municipal bonds should remain robust, given attractive absolute and tax-adjusted yields and continued investor appetite for high-quality fixed income. However, states will have to navigate softer tax revenue as federal pandemic aid is exhausted.

FIGURE 2

Key macro drivers and how they may play out in our base case, best case, and worst case scenarios.

Scenarios	Base Case	Best Case	Worst Case
Government Policy	Balanced mix of prudent and pro-growth fiscal policy, only targeted and not blanket tariffs, and deregulation.	The imposition of tariffs is only threatened but never implemented, and the Trump administration focuses on prudent and pro-growth fiscal policy and widespread deregulation.	The Trump administration prioritizes large and broad tariffs and significant immigration curbs. The implementation of tax cuts is delayed to the end of the year, while the negotiating process engenders fiscal sustainability concerns given the expected impact on the federal budget deficit and debt.
Economic Growth	Income growth and therefore household consumption slow down only marginally from above-trend levels, in line with cooler but still healthy labor market conditions. Deregulation adds another tailwind to productivity growth.	Income growth and therefore household consumption continue to run above-trend thanks to a rebound in labor market conditions, and wage growth reaccelerates. Deregulation adds another tailwind to productivity growth.	The combination of a rapid deceleration in income growth and rising inflation dents consumer confidence and spending, unemployment rate rises, and short-term productivity growth falls as business investments slow down.
Inflation	The targeted nature of trade tariffs limits their impact on consumer prices, and inflation stabilizes, albeit at levels higher than 2%.	Despite strong spending and wage growth, productivity growth minimizes the inflationary impact of elevated consumer demand and higher labor costs.	Aggressive trade tariffs lift goods prices for households and businesses. However, higher prices cause a drop in household spending and corporate profit margins. As a result, weaker demand offsets the tariff-induced price increases after the initial spike.
Monetary Policy	The Fed is able to continue cutting rates gradually towards "neutral."	The Fed establishes that the "neutral" rate is between 3.5% and 4% and stops cutting rates in early 2025 as the economy has entered a new phase and is able to generate solid growth at higher levels of interest rates relative to the post-2008 decade.	The Fed faces a very challenging combination of rising prices as a result of tariffs and rising unemployment as a result of business uncertainty and falling profit margins. It cuts rates slowly at first, but then has to ease aggressively to stimulate weak economic and labor market conditions.
Cross-Asset Implications	In this scenario, we would expect equity performance to moderate after two consecutive years of 20%+ total returns. Given elevated valuation levels, the bulk of equity returns would come from earnings growth (~13% expected in 2025 for S&P 500 companies), with a narrowing differential between the Magnificent 7 stocks and the average large cap stock. Bond volatility could stabilize, leading to positive fixed income returns driven by coupon payments.	In this scenario, earnings growth could surpass current expectations and drive another year of above-average performance for U.S. stocks. We would expect small caps and value stocks to outperform. High yield bonds would continue to outperform investment grade and Treasury bonds.	In this scenario, earnings growth would come in well below current expectations, and equity valuations would contract from elevated levels, leading to a market correction and a rise in volatility. Treasury bonds would likely outperform equities, while riskier bonds would underperform.

Source: TIAA Wealth CIO.

U.S. CONSUMER OUTLOOK

Will the U.S. consumer be able to sustain the robust level of spending we witnessed in 2024?

Since 2020, the U.S. consumer has been the indefatigable engine of economic growth, with personal consumption expenditures accounting for more than 80% of total U.S. Gross Domestic Product (GDP) growth. Consumer spending has grown 8.3% on an annualized basis since the end of 2020, more than double the pre-pandemic, ten-year annualized rate of 4%. Given the significant rise in consumer prices, not all this growth comes from increased volumes; however, even after adjusting for inflation, consumer spending has grown 3.8% on an annualized basis over the same period—considerably higher than the 2.4% pre-COVID annualized rate.

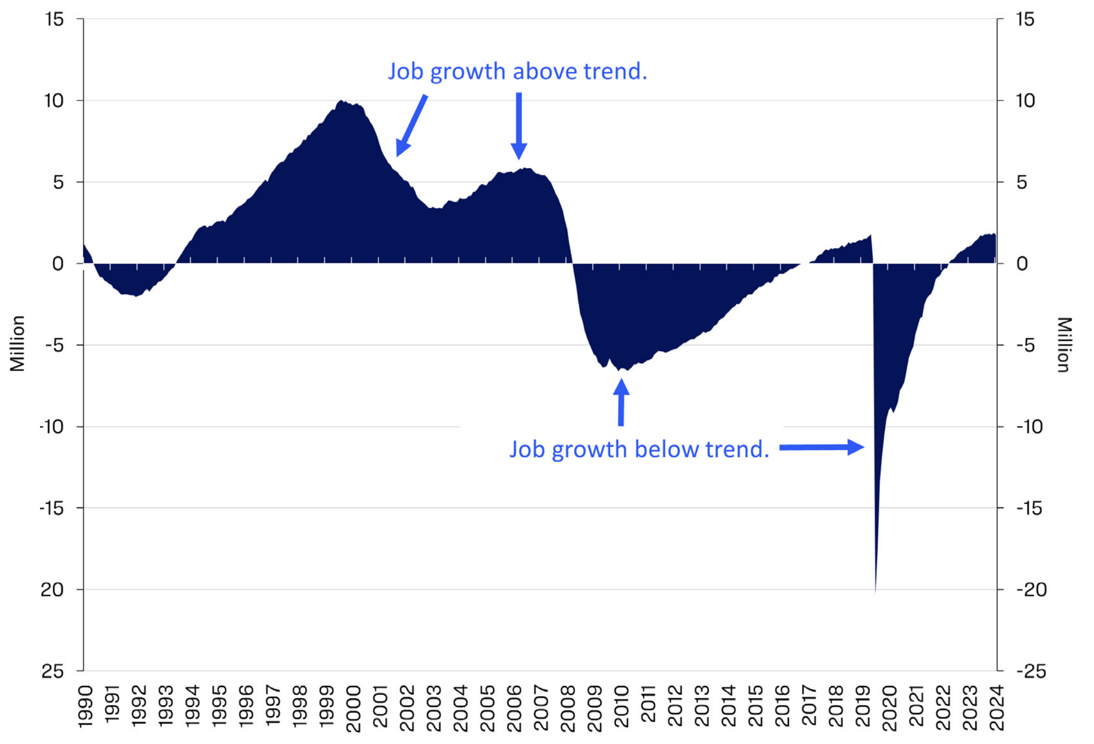
It is therefore crucial to assess the evolution of the dynamics supporting such resilient consumer spending, as well as the downside risks that could undermine the financial health and confidence of U.S. households:

- The inability to satisfy normal spending habits during the worst days of COVID, as well as significant government transfers to supplement income lost due to rising unemployment, led to the accumulation of large excess savings that, by some estimates, reached ~$2.5 trillion on aggregate by the end of 2021. These savings provided households with much-needed extra resources to combat rising consumer prices, but have been largely spent down by now, especially by lower-income families.
- Household net worth[5] has increased by ~40% since the end of 2019, according to Federal Reserve data. As we discussed in our Focus*Point* article "The Household Wealth Effect – From Wall Street to Main Street," the primary impact of a rise in household net worth is on consumer confidence, as households feel more financially secure and compelled to keep spending. However, our view is that this dynamic is a complement rather than a supplement to income growth and depends on a continued rise in financial and non-financial asset prices.

- Since April 2020, the U.S. economy has created more than 28 million jobs. However, most of this employment growth was driven by the gradual recovery of the labor market from the extreme disruption caused by the pandemic; non-farm payrolls didn't reach levels implied by the pre-COVID trend until the end of 2022, and they have risen just moderately above trend since. Employers, therefore, are unlikely to view their headcounts as excessive, thus reducing the risk of widespread layoffs. A healthy labor market is the key to sustained income growth. Disposable personal income has grown by 5.5% (annualized) through Ocotober 2024, a pace consistent with ongoing consumption resilience. That said, employment growth has slowed to an average monthly pace of ~130,000 jobs over the past six months (as of October 2024), compared to 230,000 jobs over the prior six months and 314,000 jobs between the end of 2021 and the end of 2023 (Figure 3). We expect softer labor market conditions to push disposable income growth down toward its pre-pandemic pace (~4% annualized), causing a moderation in personal spending, albeit to a still healthy level.

FIGURE 3

Total non-farm payrolls are only slightly above trend, following an extended period of post-pandemic recovery.



Sources: Bureau of Labor Statistics, TIAA Wealth CIO (data through Dec. 2, 2024).

What are the key risks that could cause a sharper slowdown in income growth and therefore in spending growth?

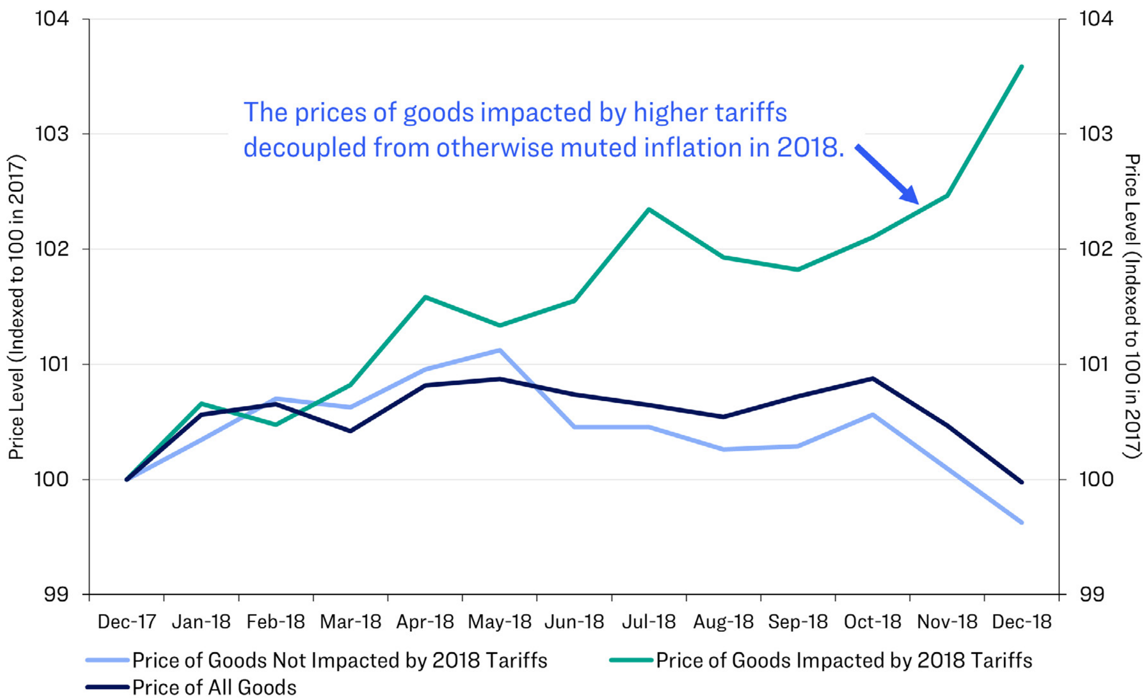
- Uncertainty about the new administration's policy priorities—and their impact on input prices, interest rates and consumption trends—could affect business confidence and, more pointedly, profit margins. This could cause a further slowdown in employment growth, which, in turn, would slow income growth.

- Disposable personal income rose ~13% between 2021 and 2022; however, elevated price inflation eroded much of this increase, causing real disposable income to stagnate over the same period. Since 2022, price inflation has moderated more quickly than wage inflation, and real disposable income has risen by ~7% as a result. The inverse dynamic, where nominal income growth slows down as expected while inflation reaccelerates, would dent consumer confidence already fatigued by declining affordability.

We are monitoring trade tensions particularly closely, with an eye to the 2018 experience of rising tariff rates. Back then, the price of goods impacted by higher duties rose materially throughout the year, bucking the trend of otherwise muted goods inflation (Figure 4). This effect went relatively unnoticed, given the targeted nature of tariffs and the low inflation environment (PCE prices rose 5% between 2017 and 2019). Our view is that the risks are higher today, given the threat of a much broader implementation of trade tariffs, as well as already challenging price affordability (PCE prices have climbed almost 18% since 2020).

FIGURE 4

The impact of higher tariffs on goods prices was evident in 2018.



Sources: Bureau of Labor Statistics, Office of the U.S. Trade Representative, TIAA Wealth CIO (data for full calendar year 2018).

KEY FISCAL AND LEGISLATIVE POLICY ISSUES

What fiscal and legislative policy issues will investors focus on in 2025–26, and should we expect a return of the "bond vigilantes" based on recent U.S. election outcomes?

For all but a few of the past 80 years since the end of WWII, the U.S. federal government has spent more money than it has taken in. In doing so year after year, the central government has amassed a debt (the cumulative sum of all those annual deficits) of more than $36 trillion dollars. At 123% of GDP, the debt-to-GDP ratio at the end of fiscal year 2024 surpassed levels reached immediately following WWII (Figure 5). Excluding intragovernmental debt, the ratio of debt held by the public as a percentage of GDP is currently 100%, and the Congressional Budget Office (CBO)—a nonpartisan arm of Congress that provides analysis of budgetary issues for lawmakers—is projecting it to rise to 122% by the end of 2034.

FIGURE 5

U.S. fiscal dynamics: 2016 vs. 2024.

GROWING FEDERAL DEBT

	2016	2024
Federal Revenue*	**$3.3 trillion**	**$5.0 trillion**
Individual Income Taxes	$1.6 trillion	$2.5 trillion
Payroll Taxes	$1.1 trillion	$1.7 trillion
Corporate Taxes	$300 billion	$570 billion
Tariffs	$34 billion	$100 billion
Federal Spending	**$3.9 trillion**	**$6.6 trillion**
Mandatory	$2.4 trillion	$4.0 trillion
Discretionary	$1.3 trillion	$1.7 trillion
Net Interest	$241 billion	$870 billion
Federal Budget Deficit	~$600B (3.1% of GDP)	~$1.6T (6% of GDP)
National Debt** (% of GDP)	98%	123%
National Debt ($)	$20 trillion	$36 trillion
Debt owned by the public (% of GDP)	76%	100%
Total Treasury Debt Owned by Public ($)	$14 trillion	$28 trillion

*Additional other components: Excise, estate, gift taxes, misc. fees, etc.
** National debt includes total Treasury debt owned by the public plus intragovernmental debt.

Sources: Congressional Budget Office, U.S. Treasury Department, TIAA Wealth CIO.

Historically, the federal government has used fiscal policy (spending increases/tax cuts) to help balance the impact of economic slowdowns and recessions. This is sometimes referred to as countercyclical policy. Monetary policy (establishing interest rates, controlling the money supply, etc.) is also used to help manage the ups and downs of the economy. Fiscal policy is set by Congress along with the Executive Branch (aka the president). Monetary policy is set by the Fed, which is overseen by Congress.

Periodically over the past 30 to 40 years, the U.S. federal debt burden has been a concern to financial markets. The massive run-up in spending during and after the pandemic has once again pushed the deteriorating U.S. fiscal situation to the top of the list of worries for investors, most notably in the bond market.

The Republican sweep in the recent U.S. election has spurred expectations for a return of the "bond vigilantes." The term was coined in the early 1980s by renowned economist Ed Yardeni. "Bond investors," Yardeni wrote in a 1983 paper, "are the economy's bond vigilantes. If the fiscal and monetary authorities won't regulate the economy, the bond investors will." The term broadly refers to banks, hedge funds, insurers, and other institutional U.S. and non-U.S. investors who seek to enforce fiscal discipline by driving up government borrowing costs. In effect, the investors create a buyers' strike, resulting in a surge in bond yields to help tame spending and/or tax cut ambitions by making borrowing more costly.

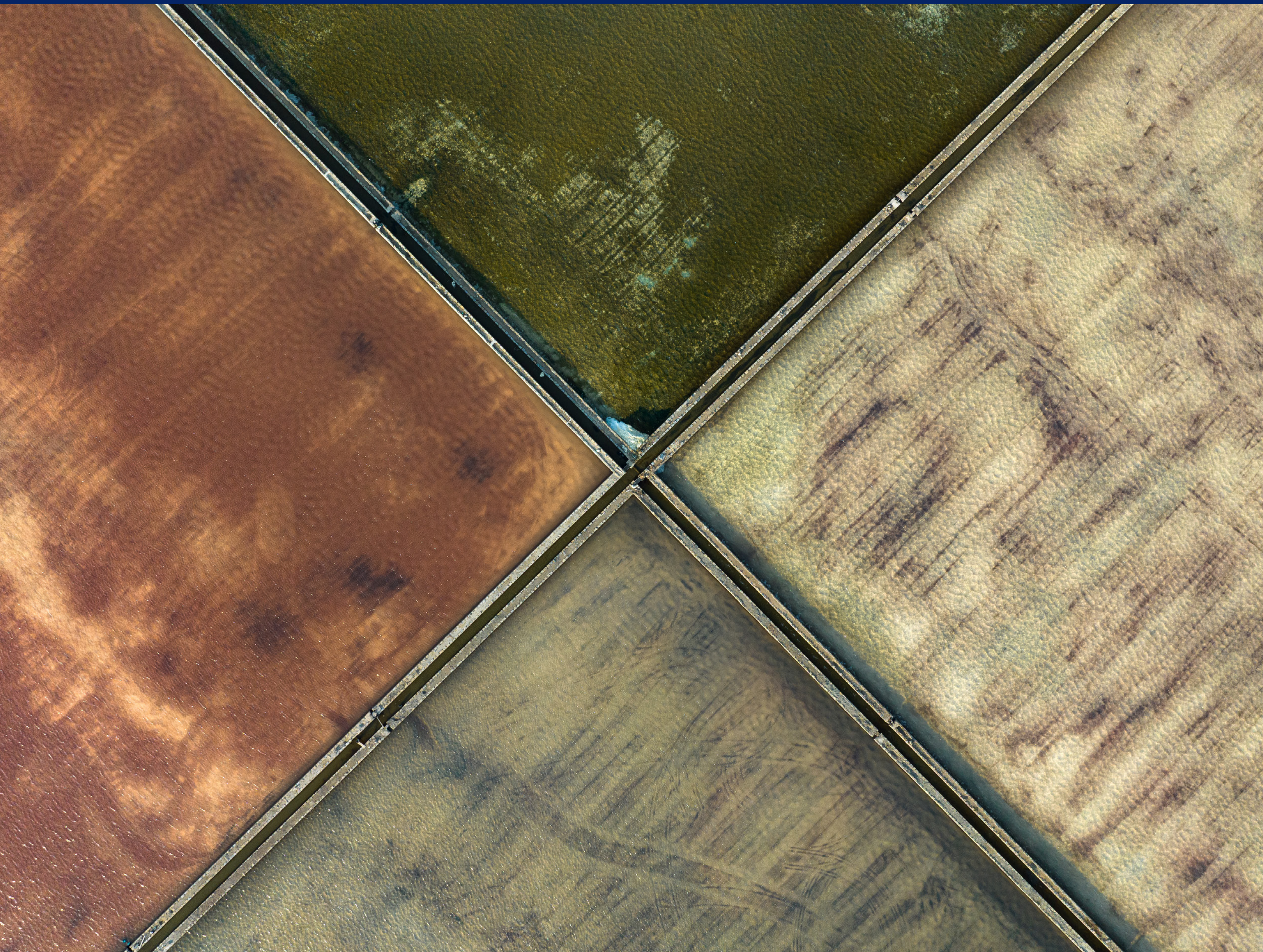
While there isn't a precise method for quantifying the impact of bond vigilantes, it is generally expressed in the term premium, or extra yield, investors demand to purchase longer-term bonds versus rolling over short-term maturities. Growing concerns over the sustainability of fiscal policy are reflected in the higher term premium or additional compensation required to move further out the maturity spectrum. Bond vigilantes have surfaced numerous times throughout history to push back against unfavorable policies.

During the early stages of President Bill Clinton's first term, he proposed increasing spending coupled with a middle-class tax cut. At the time of his proposal, inflation was moving higher, the economy was expanding with a growth rate over 5.0%, and the Fed was embarking on a rate hiking campaign. The bond market pushed back as bond prices fell and the 10-year yield rose from 5.2% to just over 8.0% from October 1993 through November 1994. The Clinton administration and Congress received the bond market's message by reducing spending as well as the deficit, while also implementing tax hikes. In response, the 10-year yield fell to just over 4% by the end of 1998.

A more recent example, known as the “Liz Truss moment,” occurred in Great Britain during September 2022. In her budget announcement, new Prime Minister Liz Truss proposed the biggest tax cuts since 1972 with no details on how the cuts would be funded and inflation near a 40-year high. The U.K. bond market reacted almost immediately, as yields on longer-dated Gilts (the U.K. equivalent of Treasury bonds) rose rapidly and the British pound fell significantly. The Bank of England had to step in to prevent a crash by promising to buy longer-dated Gilts to restore order to the market, and Truss resigned after being in office less than two months.

These examples demonstrate the powerful impact the bond market can have on excessive fiscal policies. Concerns over current U.S. fiscal policy, with growing deficit spending funded by increased Treasury issuance, haven’t resulted in a significant reaction from the bond market but have raised the prospects for higher bond yields. The new administration and Republican-controlled Congress will have to strike a balance between bigger deficit policies and keeping bond yields in check.

U.S. EQUITY MARKET OUTLOOK



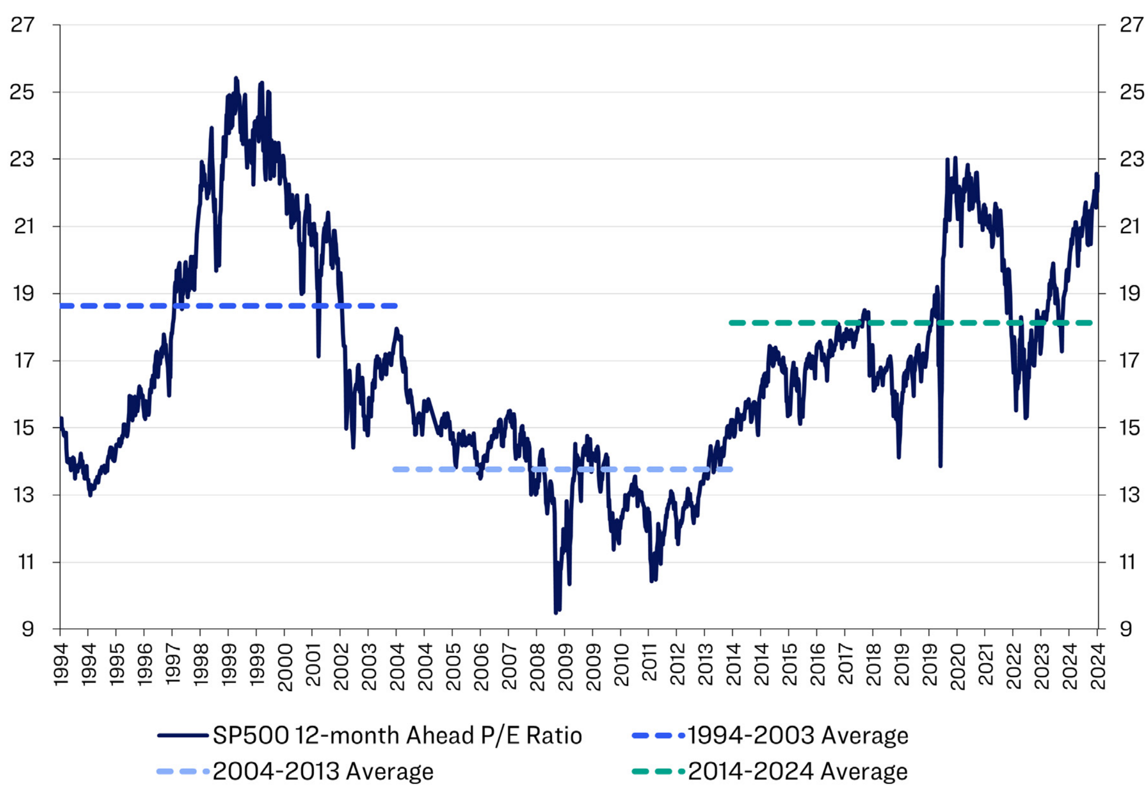
After two years of healthy gains in equities, where are valuations and investor sentiment, and what is the outlook for corporate earnings?

It's déjà vu all over again in the equity markets. Looking back a year, we were lamenting the S&P 500's rich valuation (19x forward twelve months [FTM] price-to-earnings ratio [P/E][6]) and debating the timing and the magnitude of the coming rate cuts. Jumping to today, we have an even more expensive market, and we're still debating the timing and magnitude of the Fed cuts (Figure 6).

The S&P 500 is now trading at 22x its FTM estimates (98th percentile), which is above its 5-year average of 20x, and its 10-year average of 18x. With valuations stretched, we're unlikely to get much more price-to-earnings (multiple) expansion, so the upside for stocks is likely to be dependent on earnings growth materializing as interest rates come down. Analysts are looking for a ~13% expansion in S&P 500 earnings per share (EPS) over the next year, which seems doable. The biggest wild card is rates (yet again). If rates head higher because of a reemergence of inflation, and Chair Powell is forced to pause, the equity market could stall. If the Fed can deliver another 75 to 100 basis points (bps) in cuts in 2025, we could reasonably expect stock prices to rise in the high single digits.

FIGURE 6

S&P 500 forward P/E ratio versus 10-year averages.



Sources: Bloomberg, TIAA Wealth CIO (data through Dec. 2, 2024).

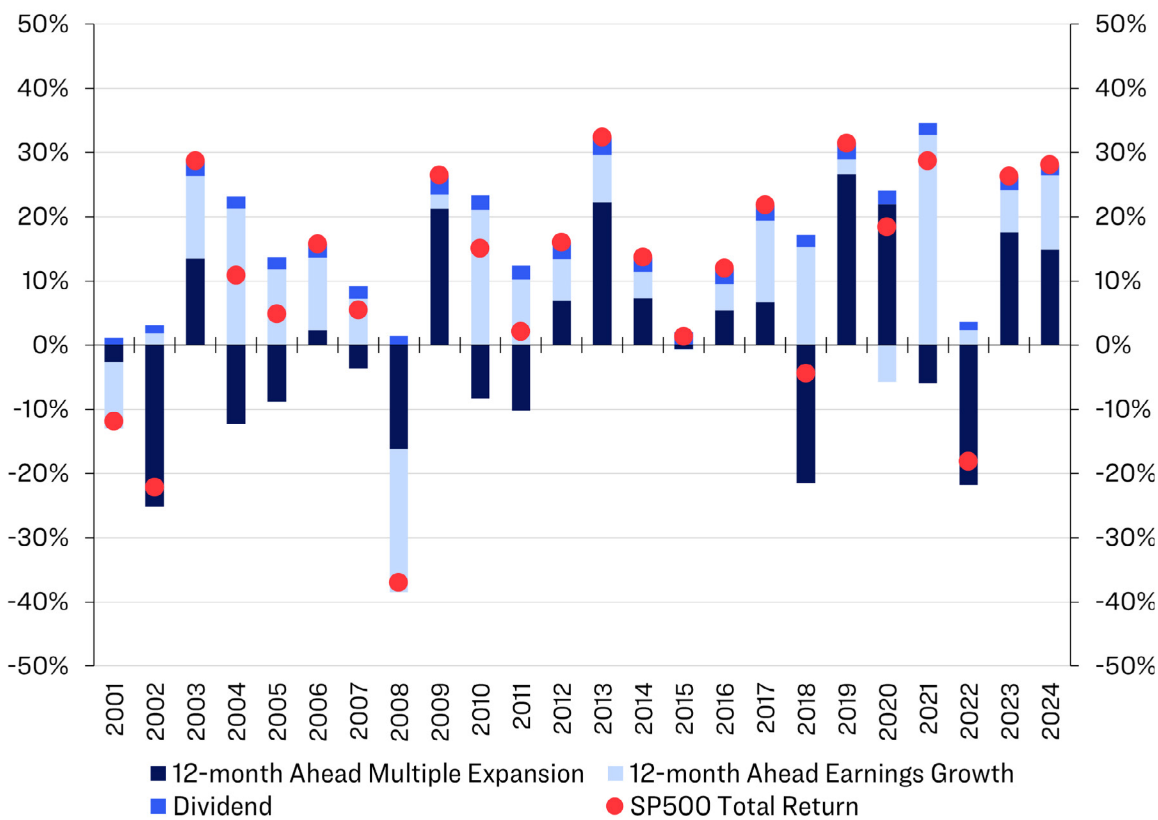
Corporate earnings surprised modestly to the upside in Q3 2024, as large-cap equities continued to see positive earnings revisions, driven by the Magnificent 7 (Mag 7).[7] However, earnings estimates continued to drift lower in small- and mid-cap companies as higher rates continued to bite. Over the next year or so, year-over-year (YoY) comparisons will start getting more difficult for these technology giants, as top-line growth goes from torrid to just strong. There is also the worry that margins for these companies may come under pressure as a result of AI-related capital expenditures (capex). Investors have bid up rate-sensitive cyclical stocks in anticipation of loosening financing conditions. However, if the Fed is forced to stop cutting rates prematurely, those stocks would likely give back some of their recent gains.

While we are still of the opinion that you don't fight the Fed and that lower rates could improve the tenor of the business cycle, we still favor equities that can grow on their own—independent of the economy as a whole (idiosyncratic growth).

Approximately 50% of the S&P 500 returns in 2024 were driven by multiple expansion, with the balance from earnings (Figure 7). Looking at the Russell 2000 (an index of small-cap stocks) over the past year, 100% of returns have come from multiple expansion. Given the elevated market multiple, we believe price growth will have to come from earnings going forward. To this effect, if enacted, the proposal to cut corporate tax rates from 21% to 15% would be a tailwind, as it would increase the reported EPS of the S&P 500 by roughly 4% (Figure 8).

FIGURE 7

What is driving strong equity performance?



Sources: Bloomberg, TIAA Wealth CIO (data through Dec. 2, 2024).

FIGURE 8

A cut in the corporate statutory tax rate from 21% to 15% is estimated to be a 4% benefit to S&P 500 EPS.

Sector	Potential EPS Benefit
Consumer Discretionary	6.8%
Communication Services	5.1%
Financials	4.6%
Health Care	4.3%
Industrials	4.3%
Consumer Staples	3.4%
Information Technology	3.2%
Materials	2.8%
Energy	1.7%
Real Estate	0.5%
Utilities	0.1%
S&P 500	**4.0%**

Sources: Bank of America Global Research, TIAA Wealth CIO.

Looking toward the future, AI demand trends remain strong as the hyperscalers (Amazon, Meta, Microsoft, and Google) continue to pour capex into building AI data centers. These cloud computing hubs will eventually host AI functions and programs, also known as models. The current infrastructure phase of AI development favors “pick-and-shovel” type companies, such as semiconductor manufacturers. The nexus of AI-related revenue and earnings growth will eventually shift from training (building the infrastructure) to inference (running the models). This eventual shift will favor the hyperscalers (software companies) that are making these sizable capex investments currently. As compared to the buildout of AI infrastructure, the AI software era will be much longer lasting and will offer the opportunity for select winners to compound their gains. While the path of progress will be uneven, we continue to believe AI will present an investable theme for the next 10 years.

INTERNATIONAL DEVELOPED AND EMERGING MARKETS OUTLOOK

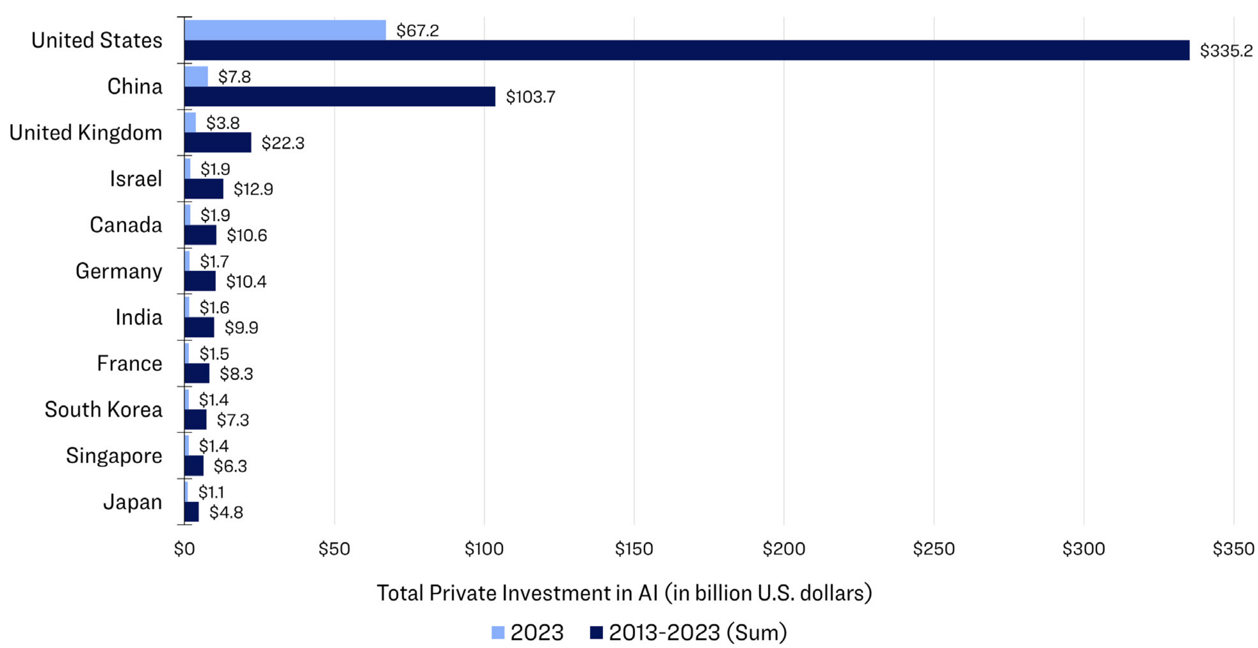
International equities have lagged U.S. equities since 2019. What is the CIO's view on International Developed and Emerging Markets?

Since the end of 2019, the Russell 1000 Index has outperformed the MSCI All-Country World Index (ACWI) ex. USA by ~70%. International stocks are now trading at the deepest valuation discount ever relative to U.S. large-cap stocks. The Russell 1000's trailing P/E ratio[8] is now 89% higher than the ACWI's, compared to an 11% average premium since 1990. While this growing valuation gap between U.S. and non-U.S. stocks looks increasingly stretched, there are several secular and cyclical trends that are driving it:

- Long-term economic growth potential is the byproduct of labor force and productivity growth. Both elements are much more promising in the U.S., indicating that the U.S. economy's outperformance relative to other developed markets and China could continue or even accelerate. Over the next 20 years, the working-age population (people aged 15 to 64) is projected[9] to grow by slightly less than 3% in the U.S. (although this estimate is vulnerable to a drastic change in immigration flows), even as the same demographic is projected to decline 14% in the Euro Area, 21% in Japan, and 16% in China. Productivity growth, meanwhile, has averaged 1.8% annually in the U.S. since 2018, compared to 1% in the Euro Area (and -0.5% in 2023). AI is expected to be at the core of productivity gains over the next several years, and Figure 9 shows the staggering first-mover, competitive advantage the U.S. economy is building on that front.

FIGURE 9

The U.S. is building a big competitive advantage in the AI space.



Sources: Stanford University, TIAA Wealth CIO (data through Dec. 31, 2023).

- Trade tariffs, a cornerstone of President Trump's economic agenda, are a key risk for international stocks. In many countries, domestic demand is too weak to fully absorb the domestic production, forcing those countries to rely on strong U.S. imports to support economic growth. An escalation of trade tensions would risk disrupting this dynamic, further dampening growth prospects for export-oriented economies like the Euro Area, Japan, China, and important emerging markets like Mexico and South Korea.

- If the new administration's policy mix causes a further rise in the U.S. dollar (USD) and long-term yields, this combination would likely put pressure on emerging economies, especially those with a more tenuous fiscal position and a larger share of debt denominated in USD.

- Geopolitics will continue to play a part in 2025. What we are seeing as we turn the page on 2024 is a tentative de-escalation between Israel, Iran and its regional proxies, although tensions seem to have flared up again in the conflict between Russia and Ukraine. More progress in 2025 toward ceasefires or more durable truces on both the Middle East and Ukrainian fronts would be a marginal positive for global markets. It could particularly benefit key economies like Germany, where electricity prices are still almost twice as high as the 5-year average before the Russian invasion in early 2022.

- Speaking of Germany, elections in the biggest European economy are now slated for February 2025. In the French election last July, Euroskeptic parties made big gains, leading to significant domestic political and market volatility; a very fragile French government is now struggling to build consensus around tax hikes and spending cuts that are unpopular and yet necessary to meet budget and debt targets. A similar success in German elections for the Alternative for Germany, Germany's Euroskeptic party, would likely complicate an already challenging policy landscape in the biggest European economy. It would further imperil the integration process crucial to the Eurozone project and therefore weigh on business confidence in the region.

- China is facing long-term headwinds, as we discussed here, but the late 2024 rollout of fiscal and monetary stimulus measures could stabilize growth and reduce near-term risks. This stimulus has so far been focused on absorbing and converting the large stock of unsold homes and refinancing expensive local government debt at cheaper rates. These measures are positive, but more is needed, in our view, with larger central government spending directly aimed at boosting consumer confidence, reviving productivity, and offsetting the demographic headwinds. Encouragingly, recent guidance by government agencies points to the growing openness to stepping up budget spending in 2025, and to doing more to facilitate the transition from a manufacturing- and export-oriented economic model to one driven by domestic consumption. Given that China will likely be the main target of U.S. tariffs, the ability and willingness of the central government to deliver such support will be key.

As a result of these factors, we caution that the wide valuation gap might not be enough to drive outperformance of international stocks, as the macroeconomic backdrop remains challenging for them. However, international stocks are trading at valuations close to their long-term average, while U.S. stocks are trading at valuations that are more expensive than 95% of all historical observations. International stocks are pricing downside risks better than U.S. stocks, and therefore play an important diversification role in balanced portfolios in the medium term.

FIXED INCOME MARKET OUTLOOK

Fixed income has generally been volatile as an asset class for the last few years. What can we expect from the taxable bond market in 2025?

Since 2022, the bond market has been characterized by heightened interest rate volatility as the Fed and investors have dealt with the lingering effects of stimulative pandemic-driven policies. The interest rate hiking campaign of 2022 through the first half of 2023—a response to the highest inflation in roughly 40 years—gave way to an extended pause that ended with an outsized 50-bp rate cut in September 2024. Following an uneven and uncertain downtrend from a peak of 5.7% to 2.8%, core PCE inflation (the Fed's preferred measure) has allowed the Fed to begin easing restrictive monetary policy toward a more neutral level. A softening but still solid labor market helps too. However, recent progress on inflation has stalled, with the inflation rate remaining above the Fed's 2% target. This, combined with significant changes to fiscal policy and with increasing concerns over rising federal deficits, is setting the stage for another volatile year ahead for rates.

President Trump will appoint a new Fed Chair once Jerome Powell's term ends in May 2026, and the Senate will have to approve the nomination. Trump has said he will not reappoint Powell, so this process—which is likely to start in the fall of 2025—will be closely followed by market participants, given that the Fed's independence is crucial to its credibility in managing the dual mandate of stable prices and maximum employment.

Treasury yields surged in October 2024 on the themes of stronger-than-anticipated economic growth, easing labor market concerns, the resilient U.S. consumer, stubborn inflation, and expectations for pro-growth fiscal policies, i.e., the "Trump Trade" (Figure 10). The Republican sweep election outcome affirmed this repricing in rates, albeit with ongoing two-way volatility, leaving levels broadly unchanged in the weeks that followed.

We believe inflation will remain the prevailing risk for Treasuries in 2025 for several reasons. The "last mile" for inflation reaching the Fed's 2% target already proved challenging during the second half of 2024. In addition, the potential implementation of sweeping tariffs and subsequent retaliatory actions is inherently inflationary, with a wide, unknowable range of possible effects. Significant immigration curbs amid an expansionary business environment (i.e., corporate tax cuts and deregulation) could also exert upward pressure on hourly wages, spurring inflation. The Fed's job will undoubtedly be more challenging in 2025 as it digests and responds to this new mix of variables. We believe the Fed will continue to lower its policy rate from a restrictive stance but with a gradual and cautious approach given high policy and economic uncertainty.

FIGURE 10

The ten-year Treasury bond yield surged in October 2024.

Sources: Bloomberg, TIAA Wealth CIO (data through Dec. 2, 2024).

In contrast to the volatile interest rate environment, the investment grade corporate credit market has shown remarkable stability at historically expensive valuations, a trend that may continue over the intermediate term. Investment grade spreads, or the yield premium over similar maturing Treasury securities, are near the tightest levels since 1998. By historical standards, all-in yields remain attractive due to the Treasury component, creating a supportive technical backdrop for these rich valuations. While the “yield” buyer has been driving the technical picture, corporate credit fundamentals continue to remain resilient as well. Investment grade credit ratings are currently sitting at a five-year high after two years of strong net upgrades. Post-COVID corporate earnings have been robust, and companies have fortified their balance sheets.

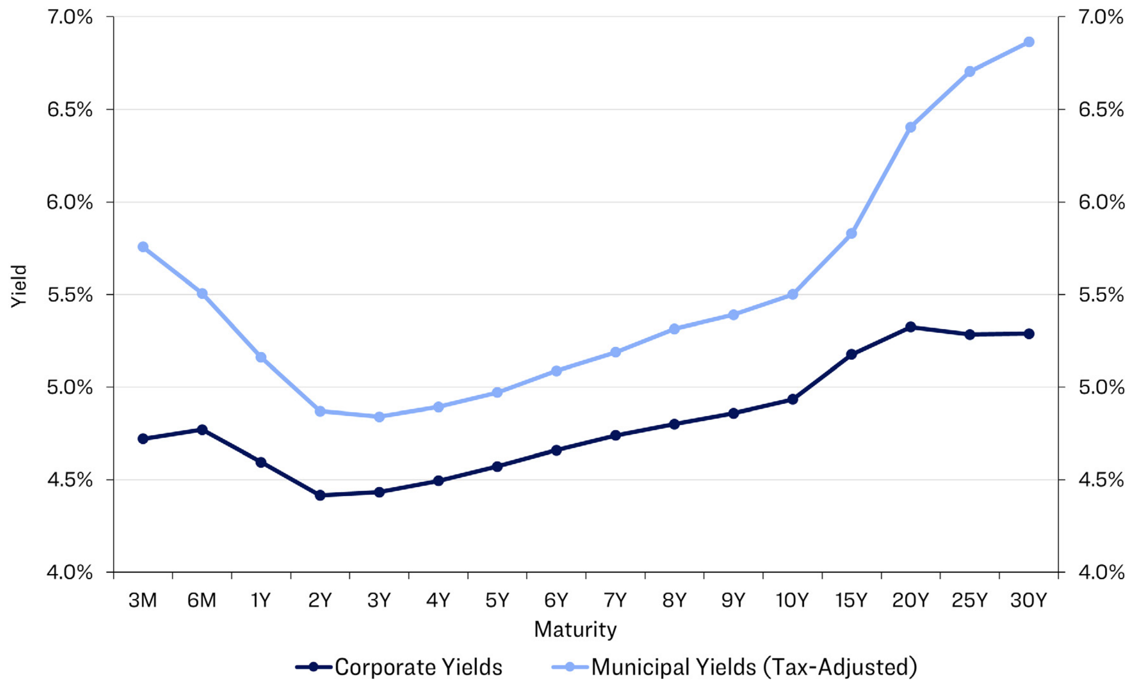
Nevertheless, given the historically small premium to own corporate bonds, any number of factors ranging from an uptick in issuance to an increase in mergers and acquisitions to a modest earnings slowdown—or even an exogenous event—could pressure credit spreads wider. Therefore, given increasing Treasury market volatility, along with policy and economic uncertainty, the risks in credit valuations are skewed to the downside. As such, the current environment warrants a cautious approach to duration and credit quality positioning.

What is the outlook for municipal bonds in 2025?

The municipal bond market in 2025 is set to offer a mix of opportunities and challenges as macroeconomic conditions, tax policies, and supply/demand conditions evolve. Following the Fed's aggressive tightening cycle over the past two years, expectations for a pause or gradual reduction in rates create a favorable environment for municipal bonds. Stabilizing interest rates offer an attractive entry point for municipal investors, particularly as absolute and tax-adjusted yields remain at decade highs (Figure 11). Demand for municipals is expected to remain robust, driven by a combination of tax efficiency and portfolio diversification needs.

FIGURE 11

Tax-adjusted yields for municipal bonds are more attractive than corporate bonds.



Sources: Bloomberg - A+, A, A- Corporate Yields; Municipal A Revenue BVAL Curve adjusted for taxes (40.8%), TIAA Wealth CIO (data through Dec. 2, 2024).

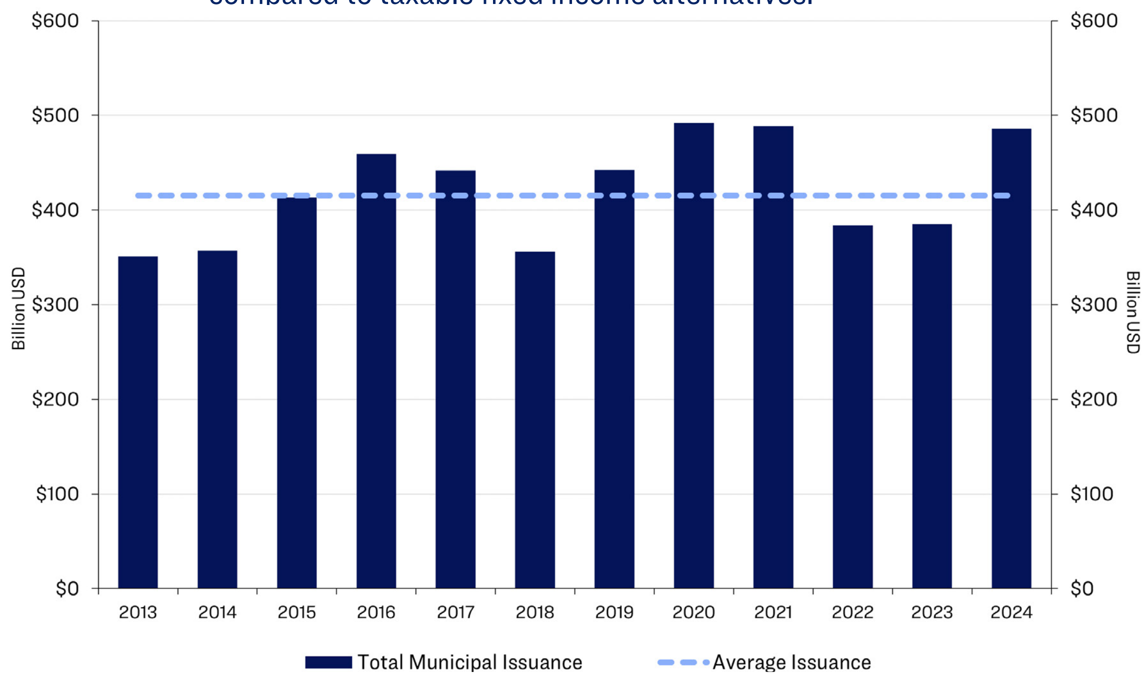
The 2024 U.S. election has increased the prospect of policy changes in Washington that could have broader implications for the economy, taxes, and interest rates. Tax policy, in particular, will play a critical role in shaping municipal market dynamics. The scheduled expiration of some provisions from the 2017 Tax Cuts and Jobs Act (TCJA) at the end 2025 may lead to some changes in the tax code. Investors, for instance, are watching debates around the potential for eliminating certain tax exemptions, particularly in sectors like healthcare and higher education.

While such measures may face significant political resistance, even the perception of such risks could introduce more uncertainty in the coming year. Furthermore, municipal bond investors should expect continued interest rate volatility, as concerns over inflation reaccelerating could lead the Fed to adopt a more gradual path of rate cuts than previously expected. Nonetheless, reinvestment risk[10] could rise if bond yields trend lower in 2025. Investors with shorter duration positioning should consider adding duration opportunistically and increasing allocations to the intermediate part of the yield curve. We remain cautious, and prefer a neutral bias, on the longer end of the curve as changes in fiscal policy and inflation expectations could lead to further steepening.

After a healthy pace of issuance in 2024, tax-exempt supply is expected to remain robust with projections of approximately $450 to $500 billion (Figure 12). However, the pace of issuance may vary due to political and legislative uncertainties. Issuers may look to fast-track projects ahead of potential tax reforms or delays tied to the post-election environment, creating periods of uneven supply. Demand for tax-exempt bonds is also likely to remain favorable, bolstered by significant cash on the sidelines, attractive tax-adjusted yields, low correlation, and higher credit quality compared to taxable fixed income alternatives.

FIGURE 12

Healthy pace of municipal issuance in 2024.



Sources: Bloomberg, TIAA Wealth CIO (data through Nov. 20, 2024).

Credit quality across the municipal landscape remains solid, supported by healthy fiscal positions at the state and local levels. Strong tax revenue growth, low leverage and healthy reserves have strengthened credit fundamentals that will help to offset any potential weakness in tax revenues in 2025. Sales and property tax growth are expected to continue to decelerate due to moderating consumer spending and rising delinquencies in commercial real estate. Slower tax revenue growth may increase divergence amongst issuers, contributing to a rise in the pace of downgrades, which have remained at historically low levels. Active management and diversification will be critical for investors looking to navigate these challenges while taking advantage of opportunities in strong sectors like infrastructure and essential services.

With favorable interest rate trends, strong demand and stable credit fundamentals, the municipal bond market is well positioned to deliver attractive returns in the coming year. However, uncertainties surrounding tax policy, supply dynamics, and sector-specific risks highlight the need for a disciplined investment strategy. By carefully navigating these factors and dynamically adjusting sector, rating and duration allocations, active municipal managers may maximize the benefits of this resilient and diverse asset class.

TAX AND ESTATE PLANNING CONSIDERATIONS

Given the new administration's plans, what tax and estate planning strategies should be kept in mind for 2025?

Tax overhaul is particularly important this year since, absent further legislation, most of the individual provisions of the 2017 Tax Cuts and Jobs Act are slated to sunset or expire at the end of 2025. The TCJA decreased individual income tax rates and expanded the brackets, so more income is taxed at lower rates. It nearly doubled the standard deduction and limited or eliminated many itemized deductions. It also doubled the gift and estate tax exemption amount. Combining the sunset of the TCJA with a newly elected president who is a proponent of lowering tax rates and who has a Republican-led House and Senate on his side, it is likely that tax reform will be a priority for the administration.

While we can't predict tax legislation before it passes, one likely result is a continuation of a majority of the individual provisions of the TCJA. We may also see an expansion of tax cuts. While on the campaign trail, the president-elect proposed eliminating income tax on tips, overtime pay, and Social Security benefits, while also allowing an income tax deduction for interest on car loans for American-made cars. While all of these new proposals may not make it into law, there are several planning strategies we will keep our eye on:

Maximizing deductions: The TCJA nearly doubled the standard deduction, resulting in a substantial number of taxpayers electing the standard deduction amount over itemizing deductions. In 2017, 31% of taxpayers itemized deductions, compared with just 9% in 2020. For those who claim the standard deduction, careful consideration should be given to charitable giving. Taxpayers can consider:

- **Using Qualified Charitable Distributions (QCDs).** QCDs allow taxpayers over age 70½ to direct up to $100,000 per year, indexed for inflation, from their IRA to a qualified charity. The amount given can count toward satisfying that year's required minimum distribution, reducing the amount subject to ordinary income tax.
- **Bunching charitable gifts.** Taxpayers who take the standard deduction may lose the income tax benefit of their charitable gifts. By bunching several years' worth of charitable gifts in a single tax year, the itemized deductions may exceed the standard deduction, recognizing the income tax benefit of their charitable gifts.

State and local income tax deduction (SALT). The TCJA capped the SALT deduction at $10,000. Legislators from both sides of the aisle have expressed interest in eliminating the cap, or at least increasing the cap, which would benefit taxpayers in higher tax states. If the cap is eliminated or lifted, taxpayers may wish to defer paying state income or property tax until 2026, where permitted.

Roth conversions. Roth conversions remain an appropriate strategy for clients looking to diversify their retirement income and for those who anticipate leaving large retirement balances to heirs. To determine if a Roth conversion makes sense, taxpayers should compare their current income tax rate to their expected rate during retirement or to their beneficiaries' expected rate. Most non-spouse beneficiaries will be required to take full distribution of retirement funds within 10 years of inheriting them, potentially increasing their tax rate. While the distribution rules are complex, converting retirement accounts to Roth may help reduce a beneficiary's income tax exposure.

POTENTIAL SURPRISES FOR 2025

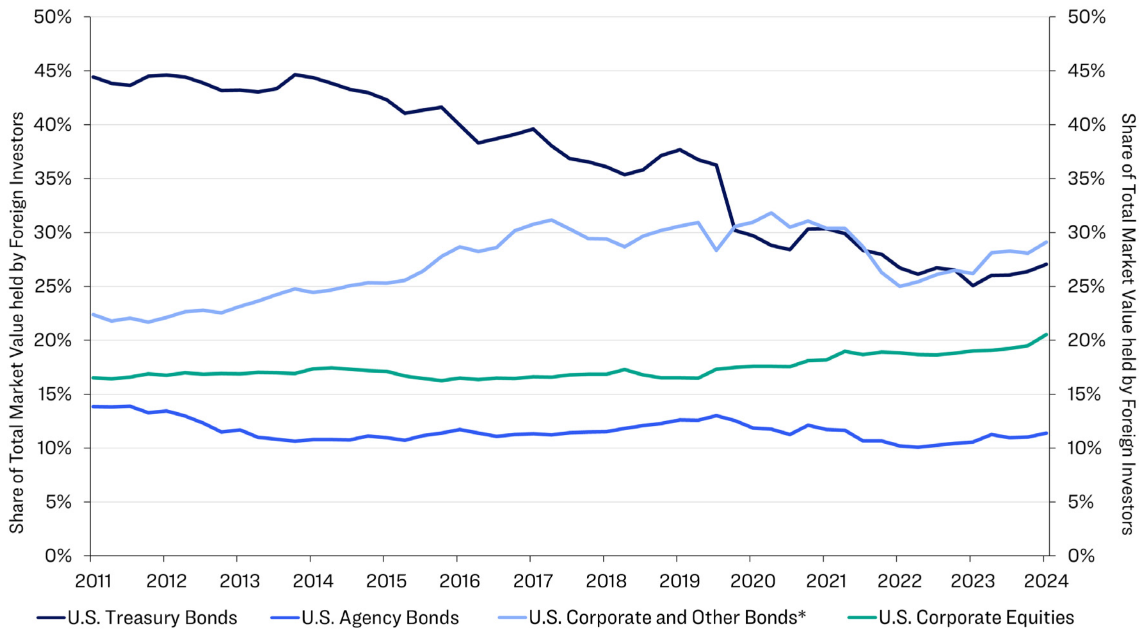
What potential out-of-consensus surprises are we monitoring for 2025?

Given uncertainty about how the economic fundamentals will respond to the evolving policy landscape, we will closely monitor three ways in which current market consensus could be upended in 2025:

- **Surprise 1: International stocks beat U.S. stocks.** Escalating fiscal concerns in the U.S. lead foreign investors to demand a higher premium (from lower valuations to a weaker dollar) to remain invested in U.S. assets (Figure 13). An increasingly protectionist stance by the U.S. drives more integration and cooperation abroad, including a significant step up in fiscal stimulus and investments in both Europe and China. The ramifications of the new U.S. administration's policy mix on inflation and growth force the Fed to keep interest rates restrictive while other global central banks continue to ease monetary policy, therefore leading to more favorable financial conditions abroad.

FIGURE 13

Foreign investors own a significant share of U.S. assets.



*Municipal bonds and asset backed securities

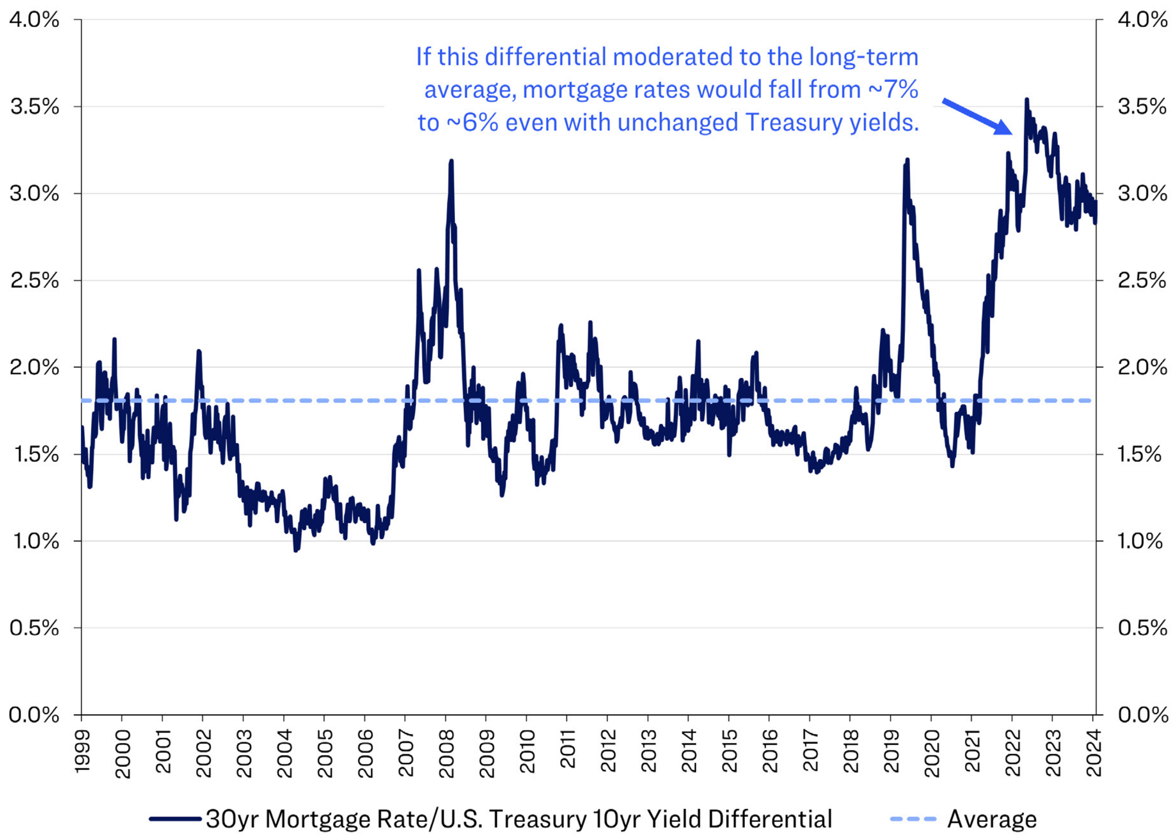
Sources: U.S. Treasury, Federal Reserve, TIAA Wealth CIO (data through Sep. 30, 2024).

- **Surprise 2: The Trump administration's policy mix will be disinflationary.** A short-lived rise in price levels following the imposition of broad trade tariffs causes corporate profit margins to shrink, unemployment to rise as a result, and consumer demand to buckle under the pressure of another decline in affordability. A drastic curb of immigration flows doesn't boost wages for a smaller labor force but instead reduces aggregate demand for anything from groceries to housing. And the focus on spending cuts is deeper than expected, reversing the sizeable fiscal support the U.S. economy has enjoyed since 2020. All these dynamics lead to lower, not higher inflation, and force the Fed to cut faster than anticipated to stem further economic weakness.

- **Surprise 3: Mortgage rates decline sharply, boosting both housing affordability and new home constructions in the U.S.** As the Trump administration policy mix leads to lower economic growth and softer inflation, the Fed continues to cut interest rates, driving a decline in Treasury yields and interest rate volatility. On top of that, looser capital regulations allow banks to increase the riskiness of their balance sheet assets, in turn driving easier mortgage lending standards and stronger demand by banks for mortgage-backed securities, therefore contributing to tighter mortgage spreads relative to Treasury yields (Figure 14).

FIGURE 14

Mortgage rates are trading at historically elevated levels relative to Treasury yields.



Sources: Bankrate.com, Bloomberg, TIAA Wealth CIO (data through Dec. 2, 2024).

[1] The Bloomberg Aggregate Bond Index tracks the performance of the U.S. investment grade bond market and is composed of both government and corporate bonds.
[2] https://www.statista.com/topics/12221/global-elections-in-2024/#topicOverview
[3] Term premium is the compensation investors require for bearing the risk that interest rates may change over the life of the bond.
[4] The neutral rate is the theoretical federal funds rate at which the stance of Federal Reserve monetary policy is neither accommodative nor restrictive. It is the short-term real interest rate consistent with the economy maintaining full employment with associated price stability.
[5] Measured as the sum of financial and non-financial assets (homes, cars, stocks, bonds, cash, etc.) held by U.S. households, net of all liabilities including mortgages and credit card debt.
[6] Forward price-to-earnings (P/E) ratio is a valuation metric that compares the current share price to the company's estimated future earnings per share.
[7] Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.
[8] The ratio of stock prices to 12-month trailing earnings-per-share.
[9] According to World Bank data.
[10] Reinvestment risk is the risk that investors won't be able to reinvest proceeds from an investment at a rate equal to or higher than the original rate of return.

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