



## Research

### Institutional Insights

# 2025 Outlook

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**FIVE POTENTIAL SURPRISES FOR THE ECONOMY AND MARKETS IN 2025**

- The two-year drop in U.S. inflation rates might not continue in 2025 due to persistent inflation pressures and the potential for new ones.
- The fiscal debate in Washington might create volatility in bond and asset markets, as legislative proposals create anxiety about exacerbating an already challenging debt outlook.
- Despite a Fed easing cycle, longer-term market interest rates may not fall as expected.
- Emerging-market equities might give U.S. stocks a run for their money, as discounted relative valuations make the positive surprise hurdle easier to clear.
- Investors might face below-average asset returns, as so much good news is already baked into consensus expectations.

## Introduction:

The stock market enjoyed favorable momentum and easier financial conditions for the majority of 2024. Equity market performance was led by large cap growth companies predominantly in the technology and communications services sectors, and most major asset categories posted positive returns.

The U.S. remained in a firm expansion, driven by solid consumer spending. Earnings trends improved, and profit margins ticked up. Although the labor market softened, recession risk appeared low.

Globally, a monetary easing trend picked up steam in the second half of 2024. Most major economies remained in expansion amid improved global financial conditions and stable employment dynamics, despite some weakness in manufacturing.

So what lies ahead for 2025?

The biggest concern for asset markets might be complacency. It's hard to consider the U.S. stock market inexpensive, which raises the question of how much of the potentially good news is already reflected in asset prices. For example, S&P 500 earnings growth expectations for 2025 stood at more than 15% near the end of 2024. Also, the equity market has experienced a lengthy period of benign volatility since the last major market disruption in early 2020.

Overall, the near-term macro backdrop does not suggest major troubles ahead. The U.S. economy is in a solid expansion, and the U.S. Federal Reserve is easing monetary policy. That said, many of the biggest changes in asset prices tend to be driven by surprises.

Following are some of the biggest potential surprises we're watching heading into 2025:

### 1. Inflation may not decline

U.S. inflation has slowed meaningfully since the 2022 peak of 9%. This "disinflation" means prices have risen at a slower pace—not that they are coming down.

Disinflation has been a key trend supporting asset prices in the last two years. Market indicators for inflation in 2025 bounced around in recent months but often reflected an expectation of a continued drop in inflation. This view is echoed by the Fed, which (in line with the markets) is expected to make additional rate cuts in 2025.

However, core inflation (ex-food and energy) for both CPI and personal consumption expenditures (PCE) remain around 3% and stopped falling in the second half of 2024.<sup>1</sup> Labor markets have cooled but are still relatively tight, keeping wage growth elevated. Solid employment conditions continue to support the U.S. consumer, as does a record level of wealth. As a result, the economic expansion continues, and services and housing-related inflation remain elevated.

Without a bigger economic slowdown, it's not clear where the impetus for softer inflation will emerge. If the Trump administration follows through with campaign proposals to dramatically increase tariff rates on China and the rest of the world, additional inflation pressures would be likely as at least some of the higher cost of imports would be passed along to U.S. consumers.

<sup>1</sup> Source: U.S. Bureau of Labor Statistics and U.S. Bureau of Economic Analysis.

Moreover, our secular (long-term) outlook suggests the backdrop is less conducive for a return to stable, low inflation than during the past two decades. Deglobalization and trade-policy pressures are widespread, disrupting supply chains, and will generate less disinflation in manufactured goods. Meanwhile, climate and geopolitical destruction are pushing up rebuilding costs, and aging demographics are restricting labor supply and contributing to higher employment costs. Consumers may be noticing these trends, as their long-term inflation expectations remain at the high end of their range over the past two decades despite the recent drop in inflation (Exhibit 1).

**EXHIBIT 1: Consumers expect higher inflation over the next 5 to 10 years.**

Consumer Long-Term Inflation Expectations



Source: University of Michigan, Macrobond, Fidelity Investments (AART), as of 10/31/24.

**2. The fiscal policy debate could matter to the markets in 2025**

Who cares about the federal debt? Perhaps at some point, it may be investors.

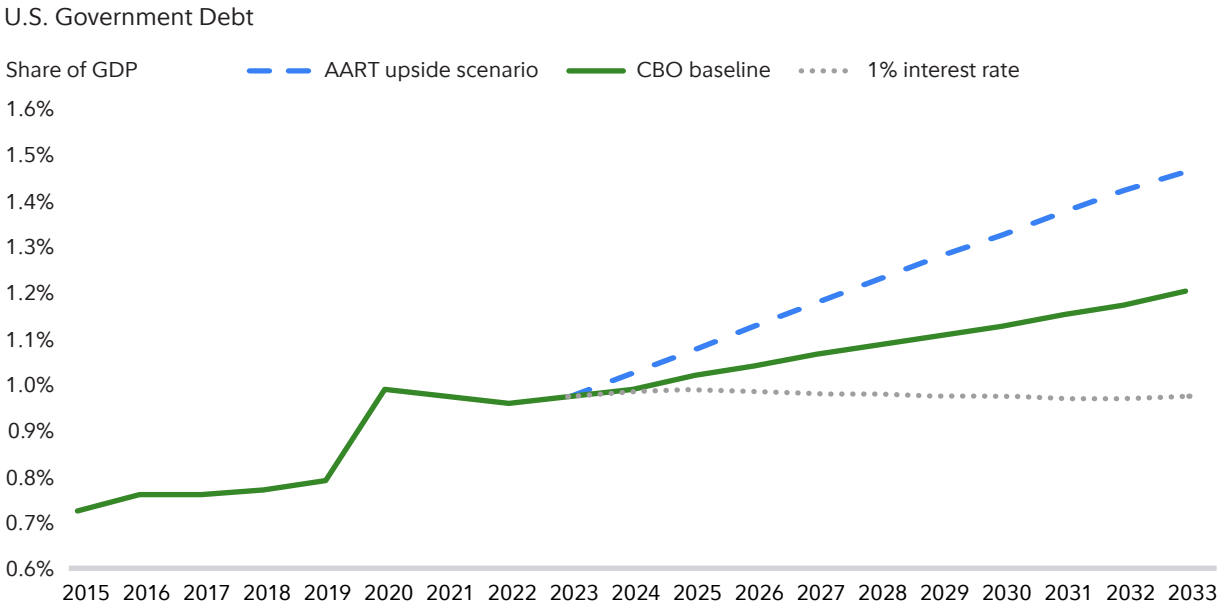
U.S. government debt (relative to GDP) tripled in the past two decades, and the 2024 fiscal deficit is near 7% of GDP, which is the highest ever experienced during a peacetime, non-pandemic expansion. To date, financial markets have expressed indifference to the deteriorating fiscal trajectory, largely because interest rates have remained low, keeping debt service manageable.

The situation could be different in 2025. The government’s net interest outlays are already at their highest level in decades, are larger than total defense expenditures, and are poised to increase further—even if interest rates don’t rise. The CBO’s base case for the next decade is for publicly held debt to rise to a record 122% of GDP. For debt/GDP to stay at current levels, interest rates would need to average 1% over the next decade (and we see this as unlikely). We believe that the path of debt/GDP is likely higher than CBO forecasts, and we estimate an upper-bound scenario based on the experience of how countries like the U.S. with aging demographics tend to face acute fiscal pressures (Exhibit 2).

Additionally, the CBO projection assumes increased revenues starting in 2026 after the expiration of the 2017 personal income tax cuts. However, an incoming Republican-led White House and Congress appear to place a high priority on extending these tax cuts, which would add \$4.6 trillion to the debt outlook over the next decade. Trump’s campaign proposals included many additional tax cuts as well.

Markets may react unfavorably if the incoming government takes steps that exacerbate the fiscal outlook, potentially placing upward pressure on bond yields and equity market volatility.

**EXHIBIT 2: An upside scenario for U.S. public debt versus the baseline.**



Source: U.S. Congressional Budget Office, Fidelity Investments (AART), as of 10/31/24.

**3. Longer-term market interest rates may not fall**

What happens if the Fed eases policy but long-term market interest rates do not continue to fall?

Ten-year Treasury yields dropped to 3.6%, down from an April high of 4.7% just before the first Fed rate cut in mid-September. This move was likely attributed to expectations for the Fed’s shift to easing, bolstered by softer employment data during the summer months. Bond yields then inflected higher after the Fed’s first cut, implying the market’s anticipation of Fed cuts had gotten ahead of itself.

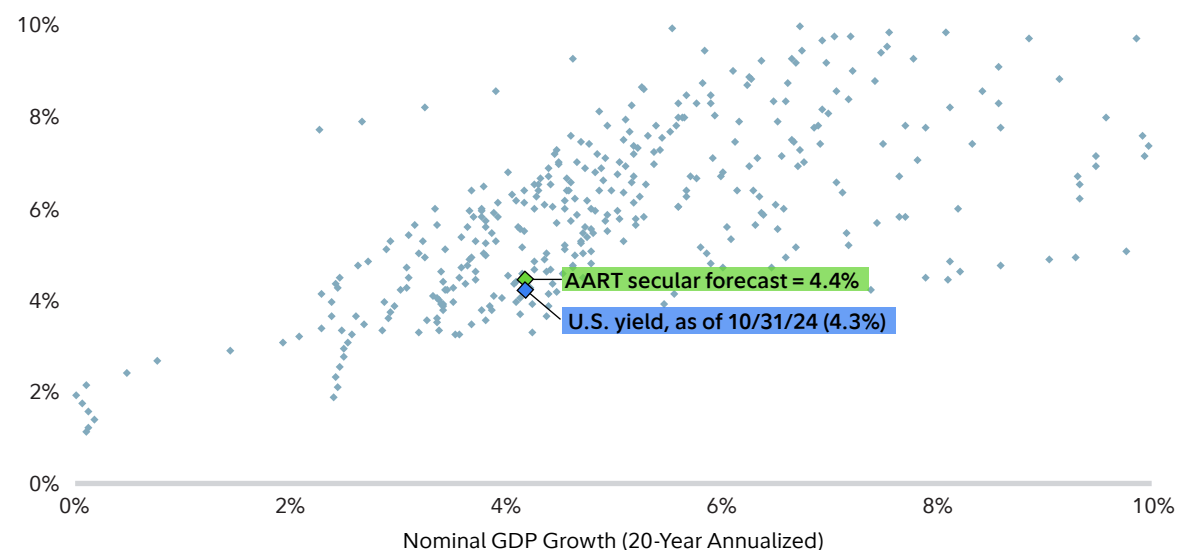
The Fed is expected to ease policy provided it believes rates are above its estimate of the neutral rate. But how many rate cuts—and whether it’s more than is already priced into longer-term bond yields—remains a key question for 2025. If U.S. economic strength, inflation, and the fiscal debate surprise markets in a way that puts upward pressure on rates, then additional Fed easing may not be able to push longer-term rates lower in 2025.

We believe the fair value of 10-year Treasury yields roughly equals the long-term potential nominal GDP growth rate, which we estimate to average 4.4% over the next 20 years (Exhibit 3). This rough proxy suggests current yields are near their fair long-term valuations. Yields could rise above fair value due to either a growth or inflation surprise to the upside and/or high deficits that would increase the supply of bonds relative to demand for fixed income securities. If yields fall significantly in 2025, it likely would be due to a weaker-than-expected U.S. economy and rising recession fears.

### EXHIBIT 3: Current U.S. Treasury yields are roughly near our long-term forecast.

#### 10-Year Sovereign Bond Yields vs. GDP

Yield (20-Year Annualized Average)



Highlighted dots are U.S. 10-year Treasury bond yields. AART secular forecast refers to an estimate for U.S. nominal GDP (4.4%). Source: Official Country Estimates, Haver Analytics, Fidelity Investments (AART), as of 10/31/24.

## 4. Emerging-market stocks could give U.S. stocks a run for their money

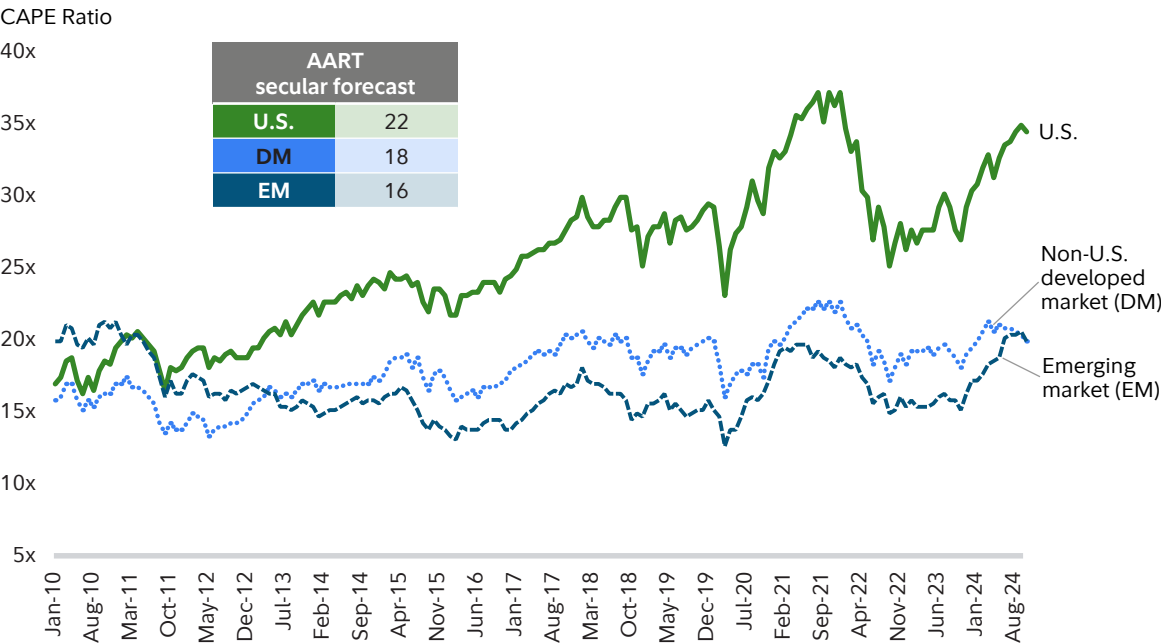
U.S. large caps outperformed their non-U.S. counterparts in 2024 and have surpassed international equities by more than 7% per year over the past decade. Investors have recognized that the U.S. has had a stronger and more resilient economy than most other developed countries, and that its return on equity has been far superior due to its more shareholder-friendly corporate management, the high levels of profitability by several large, dominant technology and communications companies, and most recently the boom in artificial intelligence (AI). The incoming Trump administration may raise challenges for other countries, including higher tariffs and more uncertain foreign policy. Some investors may think it's time to give up on global diversification.

We are not in that camp. The world backdrop may well be messy and volatile in 2025, but outperformance by emerging markets and perhaps other non-U.S. equities could happen without a reversal in positive U.S. trends. It could potentially combine relative international improvement with a conclusion by more investors that equity valuations already reflect a good portion of the good-news expectations for U.S. stocks.

Our estimates conclude that U.S. stocks should sell at a 20%–40% valuation premium with non-U.S. developed-market (DM) and emerging-market (EM) stocks over the long term (Exhibit 4). This is far out of line with the current valuation gap (70%).

**EXHIBIT 4: U.S. equity valuations rise far above our secular forecast.**

Equity Valuations



CAPE: Cyclically adjusted price-earnings. DM: Developed markets. EM: Emerging markets. Price-to-earnings (P/E) ratio (or multiple): Stock price divided by earnings per share, which indicates how much investors are paying for a company's earnings power. Cyclically adjusted earnings are 10-year averages adjusted for inflation. Source: FactSet, countries' statistical organizations, MSCI, Fidelity Investments (AART), as of 10/31/24.

Catalysts for non-U.S. stocks in 2025 may include better corporate earnings momentum (which we're currently seeing in emerging markets), a Chinese stimulus policy response that surpasses expectations (which could happen in response to higher U.S. tariffs), and a global economic acceleration on the back of central bank easing. Even if none of these events occur, there are significant country, industry, and security-specific opportunities to globally diversify a portfolio.

## 5. Asset returns might be below average

We've seen strong gains among most major asset classes in recent years. Global equities have thus far generated strong double-digit returns, with U.S. large cap stocks possibly surpassing 20% gains for the second year in a row.

With so much good news baked into consensus expectations—a U.S. soft landing, double-digit earnings growth, U.S. deregulation and potential tax cuts, global disinflation, and central bank monetary easing—many of these events may happen, and the market still might not outpace investor expectations.

High valuations set a high bar for any outsized gains in asset prices in the shorter term and tend to restrain the outlook for long-term return expectations. We have just lived through a 20-year period in which U.S. stocks outpaced investment-grade bonds by nearly 7% per year. This has been well above the 5% average over the past century. Our forecast is for U.S. stocks to outpace bonds by a much narrower amount in the coming two decades (Exhibit 5).

That said, downside surprises do not necessarily imply major trouble for financial markets. Also, a period of average or below-average returns would not be disastrous.

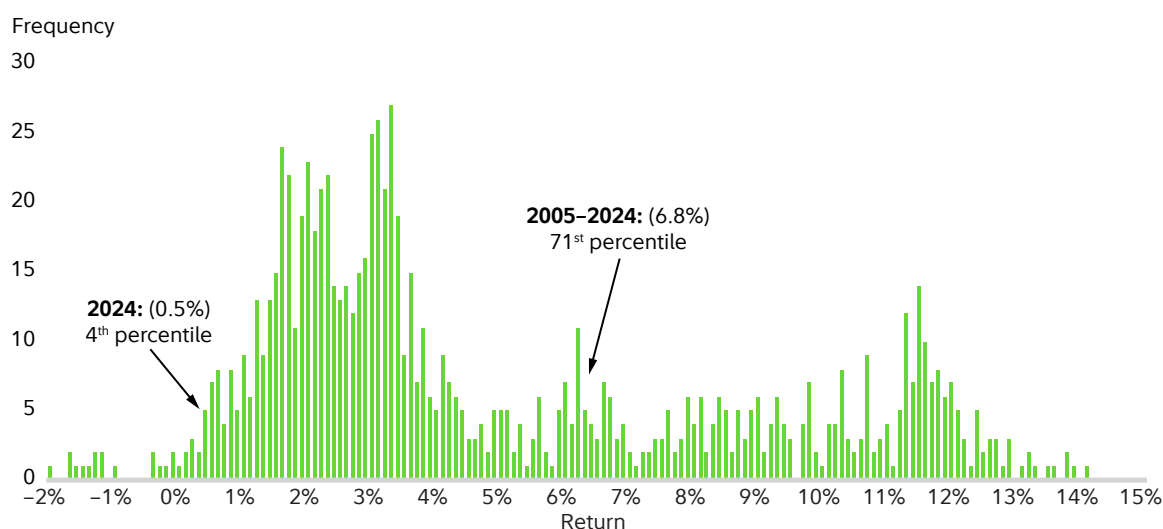
## Conclusion

Surprises are always possible, and they may be more impactful given the near-term strength of both the economy and the markets.

Longer term, we believe a healthy amount of portfolio diversification may help investors navigate a world in which upside surprises in fundamental trends may be more difficult to find.

### EXHIBIT 5: U.S. stocks could outperform bonds by a smaller margin in the decades ahead.

U.S. Equity Excess Returns Over IG Bonds (1926–2024)



**Past performance is no guarantee of future results.** Green bars represent the number of months U.S. equities relative to bonds reached the specified rolling 20-year return on the X axis. Data was calculated monthly. IG= investment-grade bonds. Geometric average returns. U.S. Equities—Dow Jones U.S. Total Stock Market Index; Investment-Grade Bonds—Bloomberg U.S. Aggregate Bond Index. Source: Fidelity Investments (AART), as of 4/30/24.



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