CAPTRUST



Preparing for the Year Ahead

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A fresh, new year is a catalyst that drives nearly everyone in the money management industry to unpack their fortune-telling tools and make predictions. These forecasts are designed to impress the public with concise narratives that sound reasonable and wise, but they often add more confidence than value in the decision-making process.

At CAPTRUST, one of our fundamental portfolio management principles is that we do not predict; we prepare. To help us understand the range of possible futures we need to prepare for, we use four levels of analysis: the range of possibilities, probabilities, market expectations, and sources of uncertainty, in that order. Each level requires a different set of subjective decisions.

We consider this preparation and prediction process to be an ongoing thought experiment, not just in January but throughout the year, and we adapt as new information becomes available. We approach this exercise, beginning to end, with a healthy dose of caution and humility.

Here are the four primary levels of analysis we conduct when evaluating the macroeconomic landscape.

Level One: The Range of Possibilities

Legendary investor Howard Marks once said, â??The future does not exist. It is only a range of possibilities.â?• In part one of our analysis, we attempt to define the range of near-term possibilities. We ask ourselves: what could the headlines say 12 months from now?

While this initial level of analysis only scratches the surface, it also provides a foundation for the other levels. In this level, the goal is not to make a prediction. Itâ??s to determine whether the full range of potential economic scenarios has a mostly negative or mostly positive bias. That is, are there more negative or positive scenarios that could unfold this year?

For 2025, we see three primary possibilities. From most negative to most positive, they are:

- **Optimism fades.** In this scenario, sticky inflation keeps interest rates high in the U.S. while global economic activity decelerates. The productivity value of artificial intelligence (AI) lags, and earnings expectations soften against a backdrop of elevated valuations.
- **More of the same.** Despite continued AI enthusiasm, inflation hovers near the Federal Reserveâ??s target range. As a result, the forward path of interest rates and market leadership remains highly sensitive to each new data release.
- **An upside surprise.** Inflation pressures continue to ease as productivity begins to accelerate, with AI efficiencies becoming more widespread. This strong economic tailwind, combined with falling interest rates, supports double-digit earnings growth across corporate America.

This level one analysis of all the things that could happen helps us understand the overall risk landscape. Then, in level two, we assign probabilities to each possibility to determine what actually might happen next.

Level Two: Probabilities

Humans have a difficult time interpreting probabilities. Early in life, most people are taught the mathematics of certainty instead, so we tend to believe there are only two probabilities: 0 percent and 100 percent. In reality, few variables across the investment landscape have such binary outcomes.

Investing requires making judgments about a future in which essentially anything is possible and nothing is certain. Understanding the probabilities of each possible scenario helps us prioritize what we need to prepare for.

Unsurprisingly, when we assign probabilities to the range of possibilities, our expected near-term future looks a lot like our recent past. This is because short-term market moves are primarily driven by momentum. Without a change in a critical market assumption, a comfortable default for most forecasters is to assume there will simply be more of the same. And indeed, more of the same is the most likely scenario for this year.

We believe each of the three possible scenarios has a percentage probability of coming true in 2025.

- Optimism fades: 10 percent

- More of the same: 50 percent
- Upside surprise: 15 percent

Based on these first two levels of analysis, you could reasonably (and accurately) deduce that CAPTRUST is predicting a generally favorable outlook for the economic landscapeâ??not the doom-and-gloom recession you might be fearing. That doesnâ??t mean a recession isnâ??t possible. It just means a recession is not highly likely.

The economy is sound, inflation is trending favorably, the labor market is robust, and under the new administration, regulatory burdens are likely to ease.

Most investment outlooks stop here and are circulated with this degree of explanation, leaving individual investors feeling empowered to take additional risk within their portfolios.

However, it is important to remember that this two-level outlook is incomplete. To be fully prepared, investors must also consider the next two levels.

Level Three: Market Expectations

One of the most difficult concepts investors must learn is that markets do not trade on good or bad outcomes. They trade on better or worse outcomesâ??that is, better or worse than what was expected.

While the first two levels of analysis are critical to understanding the economic backdrop and likelihood of certain outcomes, for investment decision-making, they are mostly useful as context clues to help evaluate whether the expectations already embedded in market prices are reasonable or not.

At any given time, current market prices incorporate the consensus investor outlook. A forecast that aligns with the consensus view will not provide excess value. Only a view that is better or worse than the consensus has the potential to add or remove value. But remember, while the consensus may not be correct, it captures the wisdom of the crowd.

The challenge is that nobody truly knows what the consensus views are. So we must interpret multiple data points, such as investor sentiment, equity valuations, earnings, interest rate projections, and credit spreads, to build estimates of consensus opinions. These data points change daily.

At present, the U.S. landscape reflects high investor sentiment, higher equity valuations, optimistic earnings projections, and near-record-low credit spreads. In other words, the consensus viewâ??like CAPTRUSTâ??sâ??is a favorable outlook for economic activity.

The question is how do CAPTRUSTâ??s expectations compare with what we believe the market is projecting?

A good economic outcome can still be disappointing if the market was expecting something great. Thatâ??s why, sometimes, the best investments are those for which people have the lowest

expectations. But also, sometimes, low expectations come with higher risk, because the consensus view is almost always based on valid reasoning.

Level Four: Sources of Uncertainty

In his 1921 book *Risk, Uncertainty, and Profit*, Frank Knight formalized a distinction between risk and uncertainty. *Risk*, he argued, is an unknown outcome for which the distribution of potential outcomes is known. *Uncertainty*, on the other hand, is an unknown outcome for which the distribution of potential outcomes is also unknown.

Astute readers may have noticed that our level two probabilities for likely economic scenarios only add up to 75 percent. What became of the remaining 25 percent? It is captured in what we believe to be an environment of heightened uncertainty. In other words, there is a 25 percent chance that something entirely unpredictable could happen.

This uncertainty is driven by a few primary factors.

Policy Questions: As President Trumpâ??s new leadership structure is finalized, we will gain clarity on his administrationâ??s upcoming policy agenda. While many expect that his proposed deregulation policies will support economic growth, many of his other proposed policy measures could create economic pressures. Itâ??s not possible to conduct mass deportations, place broad tariffs on imports, and cut $2 trillion from government spending without putting upward pressure on inflation and downward pressure on gross domestic product growth. The president and his leadership team will likely be discussing these and other economic consequences when deciding which policies to enact and their timing.

The Federal Reserve is also awaiting clarity. Fed Chairman Jerome Powell has said the Fed will remain data dependent and not consider potential policy shifts or hypotheticals in its decision-making process. This adds another element of uncertainty, potentially raising the odds of a monetary policy error.

The Domestic Fiscal Situation: The president and his team will also need to consider how proposed policies could impact the U.S. fiscal situation. Deficits, debt ceilings, and debates will likely continue to contribute to heightened unease and market volatility. However, the promise of improved productivity from AI advancements may offset anxiety.

AI Productivity Gains: Itâ??s possible that just about any short-term economic outcome could be overwhelmed by AI productivity gains and hype. However, the timeline for gains remains unclear. The AI revolution could happen fasterâ??or much slowerâ??than expected. In the meantime, as long as investors remain confident in AIâ??s long-term potential, it may not matter whether near-term corporate earnings expectations are realized.

Forecasting 2025

At CAPTRUST, we work hard to stay aware of how much we donâ??t know. The future is unpredictable, yet we revel in predicting, because a thorough prediction means we can be prepared

for a wide range of potential outcomes.

It would be easy to think thereâ??s no value in predicting. But the value is in the process, not the predicted outcomes. By trying to forecast what will happen next, we are forced to define our expectations, interpret the marketâ??s expectations, and identify sources of uncertainty.

This yearâ??s expectation: We believe the economic foundation is strong, with falling inflation, a robust labor market, a financially sound consumer, and an easing regulatory environment. Right now, weâ??re seeing high stock valuations and minimal premiums demanded for taking credit risk. This means market participants may be even more optimistic than CAPTRUST is when interpreting the forward path of the economy and the markets.

Still, weâ??re seeing elevated uncertainty, driven by shifting political policies, an unsustainable fiscal position, and soaring excitement around AI. Any of these factors could cause this yearâ??s outcomes to fall outside our expected range.

Against this backdrop, we are approaching 2025 with caution and optimism. There are many things to like about the current economic landscape. However, the combination of elevated investor optimism and heightened market uncertainty can sometimes create pitfalls. Weâ??re keeping a close eye on many factors.

This year, like in many of the years before, the most important positioning characteristic will likely be the ability to change course if the outlook changes.

Written By James Underwood.

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