



CAPITAL MARKETS FORECAST

Investing in a Chutes & Ladders Economy

Gaming Out Portfolios in 2025



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Investing in a Chutes & Ladders Economy

The year ahead will bring a new administration with new policies that, in some cases, represent significant breaks from those of the past four years. For investors, this policy discontinuity introduces uncomfortable uncertainty to the economic and investment landscapes. The particular cocktail of policies to be pursued by President-elect Trump sets up the economy and markets for a wide range of possible outcomes—potentially higher highs, but also lower lows.

This evokes the classic board game Chutes and Ladders. Like the equity markets over time, the game moves upward, making it inherently optimistic. Landing on a ladder can hurtle the player up the board in a hurry. But the game can also prove frustrating, as an unlucky spin could land a player on a chute and set them back, erasing progress in much the same way as financial markets during a downturn.

Crucially, Chutes and Ladders is a game of chance. And while all of the chutes and ladders are easily observable, whether you will land on one is entirely random. Happily, for us as investors, this is where the metaphor fails.

Unlike the game—and as with most years—pure luck will not likely make for a winning investment strategy in 2025. As with all years, the behavior of the economy and markets will follow from the choices and reactions of firms, consumers, government actors, and among market participants. While this ecosystem of behaviors is a challenging one to forecast, it nonetheless lends itself to disciplined analysis. Our economics-led investment process provides a powerful methodology to evaluate how policy choices could affect the existing trajectory of consumers and businesses—the key players in our economy.

The first of our three themes lays out our baseline expectation for the economy in 2025 and looks at potential upside risks to that baseline, referred to as “ladders.” These include accelerated capital expenditures by businesses, productivity gains, and a fiscal spending boost. Our second theme discusses the principal downside risks to the economy, or “chutes.” Here we focus on tariffs, immigration policy, and the precarious federal fiscal state, all of which present stagflationary possibilities. Our final theme maps these risks to markets and details how they could shape our investment strategy going forward.

As we start the year, there are more questions than answers. That is okay. The answers will come with time, and we will be prepared to adjust portfolios using objective analysis and risk management. And sure, a little luck wouldn't hurt, either.

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Economic Ladders



ECONOMIC LADDERS

As we enter 2025, we are optimistic that the U.S. economy will continue to climb, but we expect a deceleration following years of outperformance. After gross domestic product (GDP) posted an estimated growth rate of 2.8%¹ in 2024, we believe that it will decelerate to 1.8% in 2025. While that would be considered a solid expansion, it would also be the first time growth came in below 2% in the post-Covid era.²

The principal reason for the slowdown is the U.S. consumer. Over the past several years, the consumer helped power the U.S. to outpace other advanced economies, a phenomenon we identified in last year's *Capital Markets Forecast (CMF)* as a continuation of U.S. "economic exceptionalism." But the drivers of that consumer strength—stimulus, job growth, and wage growth—have slowed and, in our view, will not continue to power the economy. Businesses are still performing well and contributing their part to that exceptionalism, but our forecasts for weakening labor demand and rising capital expenditures (capex) should result in overall economic deceleration.

Notwithstanding this cautious outlook, we do see several possible upside catalysts. As the U.S. readies its game piece to start the board in 2025 and prepares to spin, we outline the three most likely and impactful ladders that could give it a lift relative to our baseline forecast.

First is a boost to capex driven by tax policies sought by President-elect Trump and congressional Republicans. The second is stronger-than-expected productivity gains, which may already be in the works thanks to post-Covid investments by businesses and the hard-to-predict impacts of artificial intelligence (AI). The third may come as a surprise: higher federal spending. The tax policies and federal spending ladders may be limited by financial markets and Congress's willingness to take on bigger deficits (by way of higher interest rates) as the additional debt burden is priced into interest-rate markets.

A rung up for business: Capex incentives

The Trump administration is likely to extend the personal income tax cuts included in the Tax Cuts and Jobs Act of 2017 (TCJA). These provisions were already scheduled to be in place for calendar-year 2025 and were likely to be extended for most taxpayers no matter who won the election. The cuts' expected extension, therefore, does not affect our baseline forecast for 2025. Certain new business tax policies, however, could provide a boost.

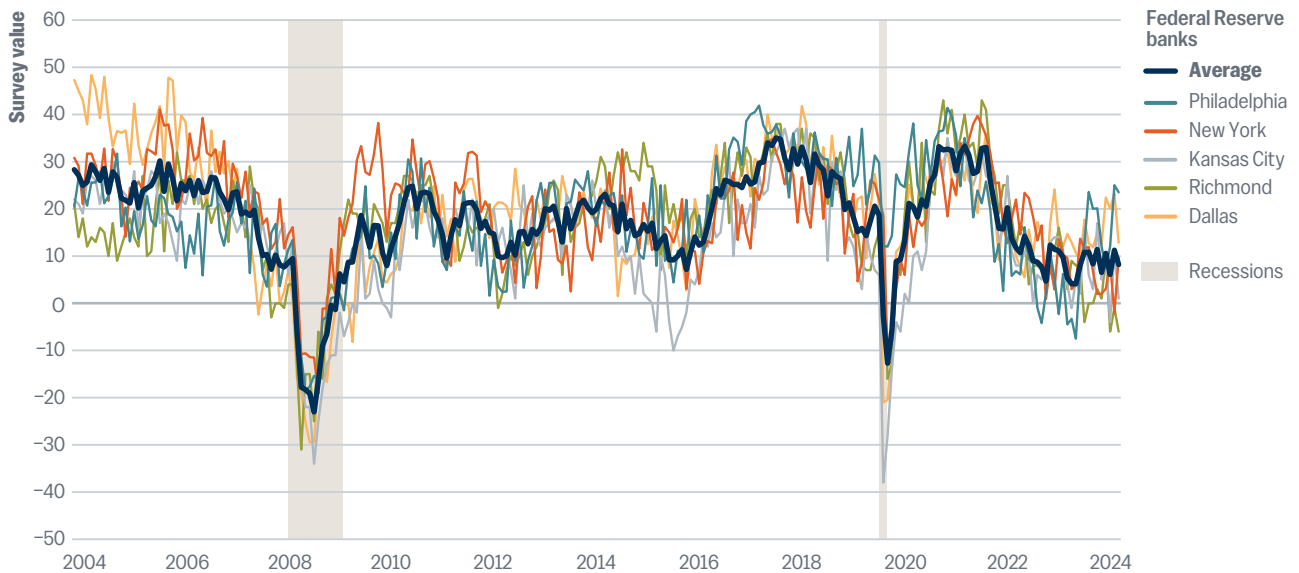
The most likely ladder for the U.S. economy is an upside surprise in capex by domestic businesses. During the campaign, President-elect Trump proposed bringing back many of TCJA's business tax provisions, but some have since expired or are being phased out. Reinstating the 100% bonus depreciation (i.e., full expensing) for tangible property and reducing corporate tax rates to 15% for domestic production could trigger a capex-led economic lift. That said, repealing green energy tax credits included in the Inflation Reduction Act could mitigate those impacts.

The TCJA attempted to incentivize capex through several measures. One key provision allowed 100% bonus depreciation of qualified expenditures on physical property made until January 1, 2023. This tax treatment has been phased out, with 80% deductibility

Figure 1

Manufacturers' outlook for capital expenditures is cautious

Federal Reserve manufacturers survey results 2004–2024



Data as of October 2024.

Sources: Federal Reserve banks, Wilmington Trust.

for capex in 2023 and 60% in 2024. It is set to decline to 40% this year, then 20% in 2026, and 0% in 2027. The TCJA also doubled the maximum expensing limit under Section 179 of the tax code to \$1,000,000 from \$500,000, a level that mostly applies to small and medium-sized businesses.

Last, the legislation allowed for owners of pass-through businesses to take a business income deduction of 20%, but that is set to expire in 2025. Other provisions in the TCJA altered the treatment of profits earned abroad for multinational corporations, allowing deductions for repatriated profits and applying a global minimum tax.

One study³ has found that the provisions boosted capex by 20% compared to domestic firms relative to a baseline. The mix of tax policies was found to stimulate domestic investment for multinationals, as those firms adjusted their blend of foreign and domestic capital.

Capex, by its nature, is critical for economic growth because it enables future production. Its salutary effect on productivity is even more vital in an economy with a slowing population and labor force, as is the case in the U.S. And it has played an increasing role in GDP growth for decades. Capex made up about 8% of GDP in 1990, rose to 11% by the turn of the century, and has continued to rise, comprising an estimated 15% of output in 2024.⁴

We see policies to support capex as possible ladders for economic growth relative to our baseline. While capex remains in positive territory, its pace has declined to the slowest in the post-Covid era and is now on par with prepandemic growth rates. Policies such as 100% bonus depreciation that favor capital-intensive industries could induce stronger capex. Surveys by regional Federal Reserve banks (Figure 1) show that the manufacturing industry, in particular, could benefit from a boost in spending, for which current expectations are muted relative to historical norms.

The longest ladder: Productivity gains

The second ladder is challenging to spot. Imagine the game board with a hidden ladder that players discover only when their piece lands there and is suddenly rocketing up the board and, even then, the piece's destination remains hidden. Such is the experience with productivity—the macroeconomic force that is the proverbial silver bullet that can propel economic growth for everyone, real wages for workers, and profit margins for businesses.

Even before the election, we noted upside risks to our baseline from a possible boost to productivity deriving from past investments with long-lived impacts, as well as businesses' ongoing adoption of AI. In our view, we may be at the beginning of a jump in productivity that could benefit economic growth for years to come.

Before the disruption of the pandemic, we identified a collection of technology forces in our 2019 *CMF* that could drive productivity, dubbing them the Fourth Industrial Revolution. Importantly, we said that the permeation of those technologies throughout industries—we called it “horizontal digitization”—was at hand (Figure 2).

The pandemic accelerated the adoption of many of those technologies, but it also obscured their impacts for several years. Specifically, supply-chain disruptions and labor-market shortages forced businesses to squeeze out more production from capital and invest in more productive technologies. Everyday examples such as ordering food or retail goods on apps that were, in turn, delivered by someone participating in the gig economy, have become commonplace. Less obvious to the public were smart shelving systems used by distributors, improved inventory management systems, and increased use of big data.



Figure 2

Technology forces can drive productivity through horizontal digitization

Cloud computing

Augmented reality

Artificial intelligence

Internet of Things

5G

Robotics

Blockchain

Big data

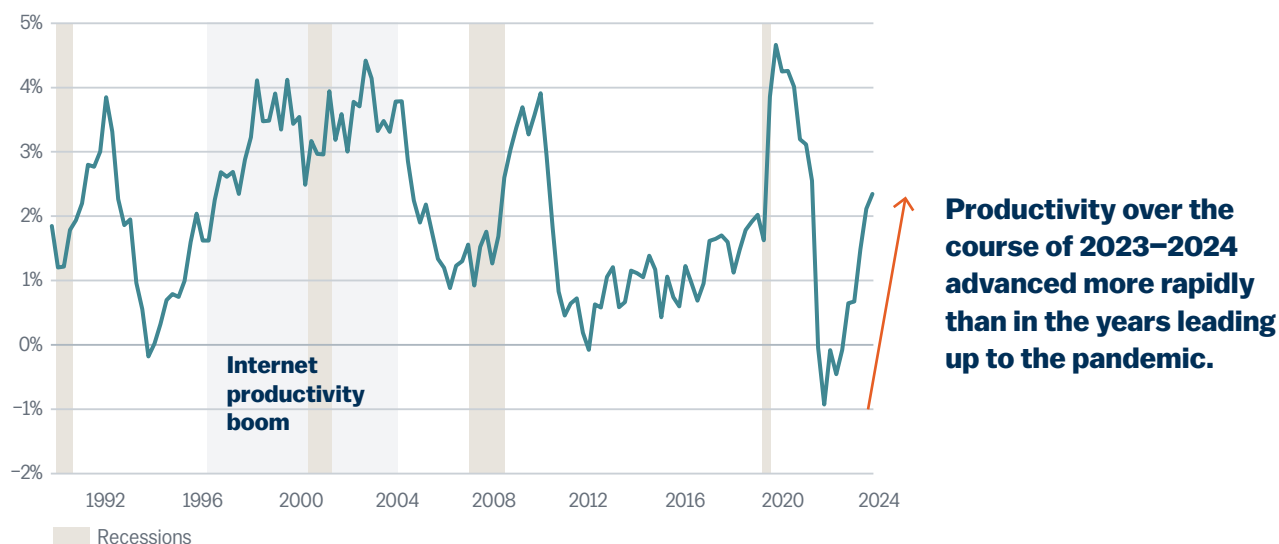
Gig economy

Source: 2019 *Capital Markets Forecast*, Wilmington Trust, January 2019.

Figure 3

Productivity is rising as we expected

8-quarter annualized growth in worker output per hour



Data as of December 1, 2024.

Sources: Bureau of Economic Analysis, Wilmington Trust.

As a result, productivity is rising as we anticipated (Figure 3). Recessions have a way of obscuring the true trend for gains, and that was certainly the case during and after the pandemic. But the most recent data show that productivity advanced more rapidly over the course of 2023–2024 than in the years leading up to the pandemic. This could be just the beginning of gains from firms adopting more technology and instituting more efficient processes.

The adoption of new technology could get a further jolt from the Trump administration's policies to incentivize capex. Such policies could boost continued investment in existing technologies, including AI. As we discuss in our final theme, "Playing the Investment Game," we are only in the early stages of consumers' and businesses' adoption of AI, a technology that we think will increase productivity for years to come.

Productivity, while uncertain, could be the biggest ladder of all. From 1997 to 2005, it reached the 3%–4% level nearly every year, even in the face of the tech crash and an economic recession. A repeat now could change the game in a massive way, and we believe adoption of AI is likely easier and will be faster than the experience with the internet 25–30 years ago. That is partly because there is no significant hardware investment required to test or implement the new technology. As we noted in "The Future of AI Is Here: Investment Risks & Opportunities," ChatGPT was the fastest-growing tech platform in history. We pointed out the long-term possibilities for several sectors, including health care and energy, and adoption by businesses has increased since then.

In "Playing the Investment Game," we continue to dig further into AI's specific benefits for corporate profitability and implications for financial-market returns. On a macroeconomic level, we believe AI could boost productivity for workers across the economy. Even if the gain was an average of just 2%–5% each year, it could provide an economic lift the U.S. has not enjoyed in a quarter century.

The policy ladder: Fiscal spending

The third possible ladder we see is a boost in federal spending as the second Trump administration takes over the game board, bolstered by single-party control of Congress. Given our baseline outlook of a slowdown in growth and on the heels of an election that hinged on the state of the economy, the incoming administration will have plenty of incentive to give spending a boost. As we detailed above, the most likely channel will be through expanded corporate capex. However, the administration could deploy targeted federal spending as well.

Our view is perhaps counterintuitive, given the rhetoric from President-elect Trump and congressional Republicans regarding the need to cut government spending, along with the proposal for a Department of Government Efficiency (DOGE)—though much of the latter may not be germane to 2025. President-elect Trump appointed Tesla CEO Elon Musk and biotech company founder Vivek Ramaswamy to lead DOGE with a July 4, 2026 deadline for recommendations, which is well beyond the timeframe we consider here and clearly giving the effort a longer-term horizon.⁵

While Musk has offered little detail on how and over what period the government may achieve massive cuts, a 2024 proposal by the Republican Study Committee⁶ (RSC) may provide insight. In that plan, mandatory spending continues to rise each year but at the same pace as GDP, essentially keeping those categories as a fixed share of the economy. Discretionary spending is held constant in dollar terms, thereby falling as a share of GDP.

The RSC's proposal does, indeed, include immediate action in 2025, but we think immediate cuts would not be seriously considered for policy. It is the long-term profile of changes to government programs, especially the mandatory programs, that offers a guide as to how a major effort to reduce deficits might progress.

There is ample opportunity in 2025 for an increase in spending even as the Trump team moves to make cuts in subsequent years. The most likely area would be defense, a category that flows into the economy through many avenues such as purchases from private manufacturers and other types of contracts. President-elect Trump pledged expansion of the military during the campaign and supports the development of an Iron Dome-like missile defense system, which was included in last year's official Republican Party platform.⁷

A boost in near-term spending would parallel the experience during the first Trump administration. President-elect Trump and congressional Republicans campaigned on balancing the budget and fiscal restraint in 2024 much the same way as in 2016.⁸ In the first two full fiscal years of the first Trump administration, though, discretionary spending rose by the most in nearly a decade.⁹ Much of the increase came from the Bipartisan Budget Act.

Although many aspects of the political environment and the economy have changed since President-elect Trump began his first term, there are more similarities than differences, in our view. We would not be surprised by an economic ladder coming directly from the Treasury's coffers in 2025.



Reducing federal spending is high on the to-do list of the Trump administration and congressional Republicans. Yet our analysis concludes that there is ample opportunity for increased spending in 2025.



Mind the Chutes

THEME II
MIND THE CHUTES

As invigorating as landing on a ladder can be, sliding down a chute brings dejection, reversing progress that had already been made up the board.

Some of the forces that can send an economy in the wrong direction are random shocks, some are economic imbalances that build over time, and some are self-inflicted. In 2025, we believe that the three chutes with the strongest likelihood of setting the U.S. economy back a few spaces fall into the self-inflicted category.

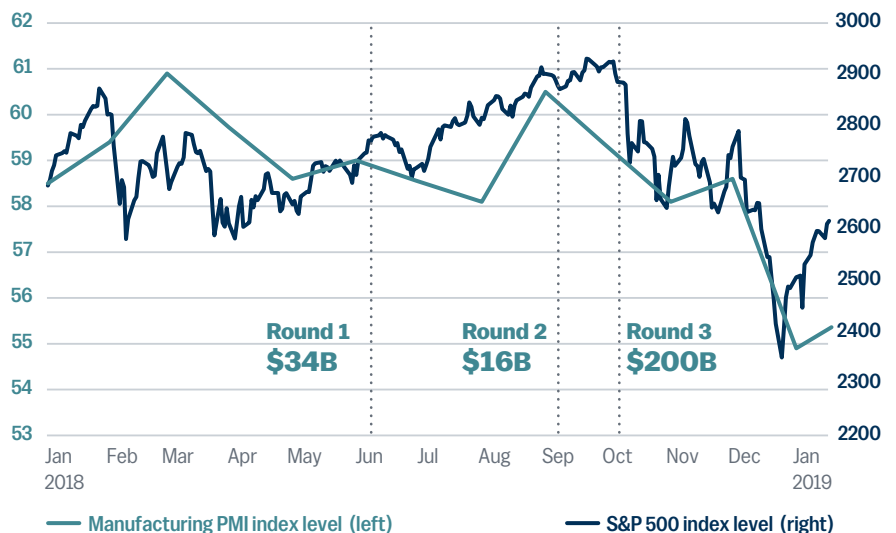
We are not politically motivated in our analysis and are not weighing in on whether any policies should be enacted. Our focus is on only the policies' short-term economic impacts as a step toward understanding how they could affect markets in 2025.

Tariffs: The most complicated of chutes

In this theme, we address the tariffs (i.e., massive and immediate) that President-elect Trump proposed during his campaign and identify them as a possible risk to the economy in the near term.

The question of tariffs is particularly challenging because we do not know how the administration will proceed. Trump is well known for using blunt language and shocking numbers, and he has proposed historically huge tariffs on imports from China and lesser tariffs on all other trading partners.¹ But his career in business and his first term as president make it clear that he also views tariffs as a tough negotiation tactic. In "Playing the Investment Game," we discuss how his approach and policies could yield positive long-term results, especially for businesses, by opening new markets and leveling the playing field with foreign competitors.

Figure 1
Equities and manufacturing activity fell after implementation of third round of China tariffs in 2018
 Changes in U.S. manufacturing activity and equity prices in 2018

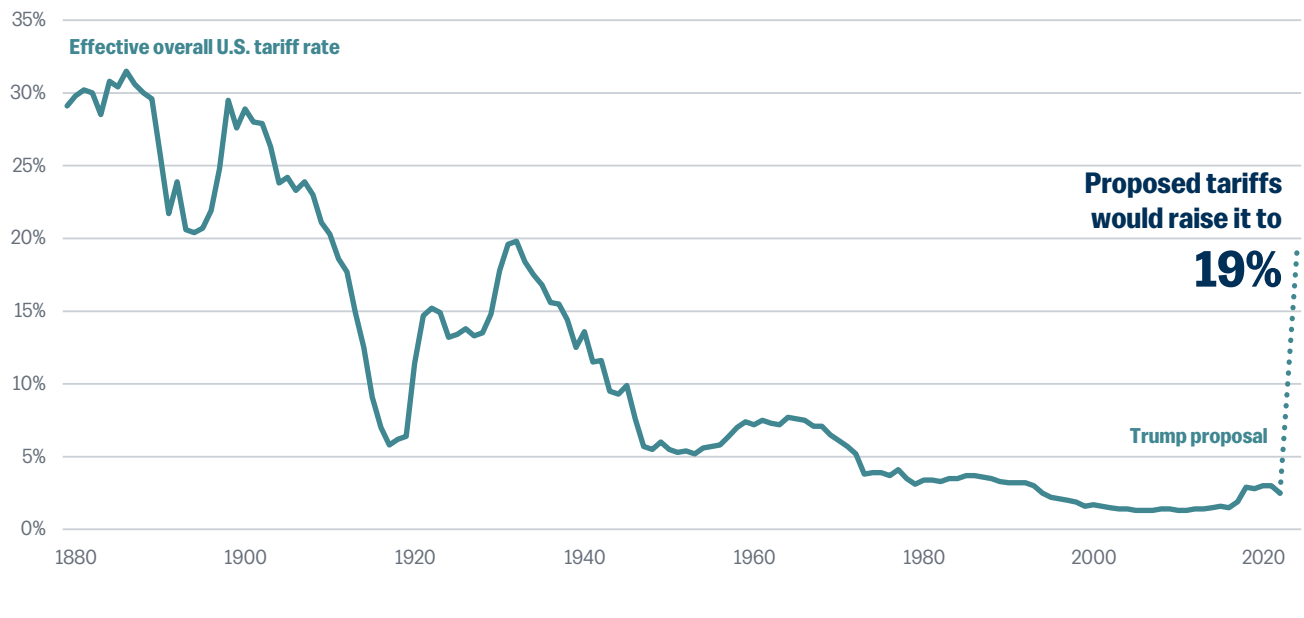


Sources: Institute for Supply Management, S&P Global, Wilmington Trust.

Figure 2

Proposed tariffs would dramatically raise effective overall tariff rate

Effective overall U.S. tariff rate 1880–2024



Data as of October 2024.

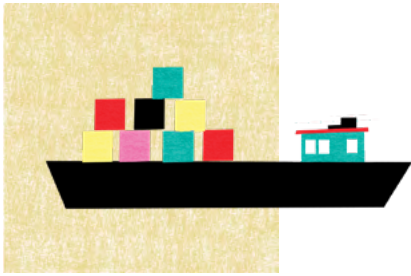
Source: *Fiscal, Macroeconomic, and Price Estimates of Tariffs Under Both Non-Retaliation and Retaliation Scenarios*, The Budget Lab.

Trump's return to the Oval Office suggests that tariffs likely will be a dominant theme for the economy and markets again in 2025. While the simple economic outcomes of applying a tariff are straightforward—higher prices and less trade volume—it is much more challenging to predict how the policies will play out. We do not expect the Trump administration to implement them to the degree proposed on the campaign trail (i.e., 60% on goods imported from China and 10%–20% on all other trading partners²), but even smaller tariffs could pose a big risk to the economy in 2025.

During the first Trump administration, successive tariffs on specific goods (i.e., solar panels, washing machines, steel, and aluminum) and on imports from China more broadly, had substantial impacts. They deservedly received the rapt attention of economists and markets. The administration implemented them sequentially over the course of 2018, with the third round in October on \$200 billion worth of imports from China—four times the size of all previous such actions combined. The U.S. manufacturing sector slowed sharply (Figure 1), and the equity market fell by 20% in the ensuing quarter.³

President-elect Trump's proposed tariffs dwarf the status quo. The policies in 2018 doubled the overall effective tariff rate on total U.S. imports to 3.0% from 1.5%. By contrast, we estimate that the tariffs proposed during the 2024 campaign would raise the overall effective tariff rate to 19% (Figure 2), the highest such rate since the extremely protectionist period between the two world wars that led to a drastic decline in international trade.⁴

Importantly, our calculation is static and does not consider the tariffs' dynamic effects, including 1) trading partners engaging in retaliatory tariffs, 2) businesses adjusting their supply chains, or 3) consumers reacting to higher prices.



The experience from the first Trump administration provides a window into these effects. Revenue from items imported from China surged in 2018 and thereafter, surpassing tariff revenue from all other countries combined (Figure 3).⁵ Businesses reacted by shifting supply chains away from China and redirecting them to other Southeast Asian trading partners, as well as Europe, Canada, and Mexico.

Gauging the economic impact of the newer tariffs is challenging, with research suggesting that they could reduce long-term GDP growth by 0.5%–1.4%.⁶ The near-term effects on households likely would be substantial, with estimates showing after-tax incomes falling 0.9%–2.6% depending on income level, with the lowest income groups hit hardest.⁷

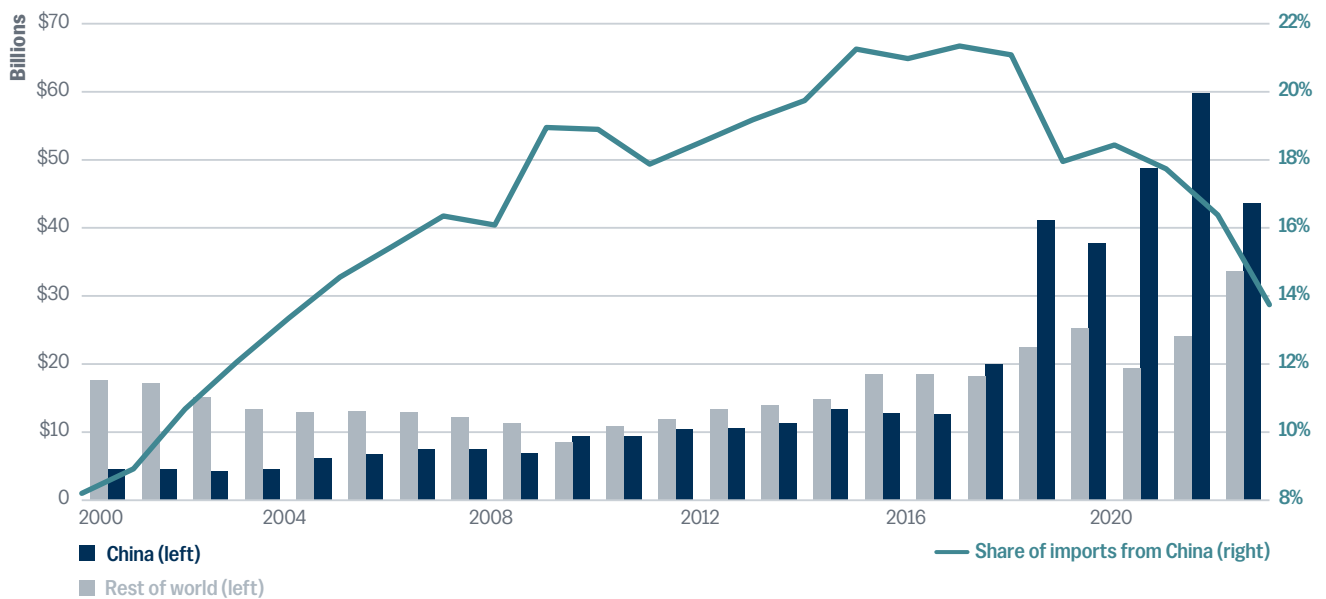
We do not expect such tariffs to be net inflationary. They likely would cause some inflation in the initial months after implementation as import prices probably skyrocket, in our view. That said, we note that inflation can truly take hold only if consumers are ready, willing, and able to pay higher prices while continuing to afford all other expenditures, such as housing, utilities, domestically produced goods, and domestic services.

With job growth waning and wage growth slowing as we start the new year, consumers are not in a position to absorb these impacts in 2025. There could be longer-term benefits from tariffs such as gains in domestic production and manufacturing jobs but, as we believe, it may not be enough to outweigh the negative effects. We think the lack of available substitutes for consumers, the shock to business supply chains, and the hit to consumer incomes could lead to a recession that, in turn, might result in low inflation or even deflation.

Figure 3

China tariff revenue surged after 2018 tariffs but trade was diverted afterward

Tariff revenues by source and China share of U.S. imports



Data as of December 31, 2023.

Sources: U.S. Census Bureau, U.S. Treasury, Peterson Institute for International Economics, WTIA.

Immigration: The lightning-rod chute

Rarely can an issue spark such heated debate as the lightning-rod issue of immigration. The policy questions are complicated, but the economic ones are less so, at least in the short term. Simply put, an influx of immigrants in the post-Covid period provided badly needed labor during the tightest labor market in a generation. That influx delivered workers to multiple industries (especially in low-skilled services), eased wage pressures, and contributed to the deceleration of inflation in 2023 and 2024.

This fresh labor injection, in turn, contributed importantly to the Federal Reserve's current easing of monetary policy. What's more, each of those immigrants and the families they supported contributed to economic growth through their own consumption. President-elect Trump's pledge to carry out the "largest domestic deportation operation in American history" could lead to labor-market shortages and economic weakness.

As of 2022, there were an estimated 11 million illegal immigrants living in the U.S., with about 8.3 million of them—75%—in the workforce.⁸ That figure translates to 5% of the total labor force and has likely climbed since then, given the increase in border activity and estimated inflow of illegal migrants in 2023 and 2024.

In the post-Covid period, all immigrants (both legal and illegal) gave a much-needed boost to the labor force more than native-born workers did, which is a stark change from the preceding decade. From 2009 to 2019, an average of about 400,000 foreign-born workers joined the labor force annually, while native-born workers averaged 500,000. In 2021–2023, the respective numbers were 1.4 million and 900,000 per year⁹ (Figure 4). This strong growth eased labor-market shortages at a critical

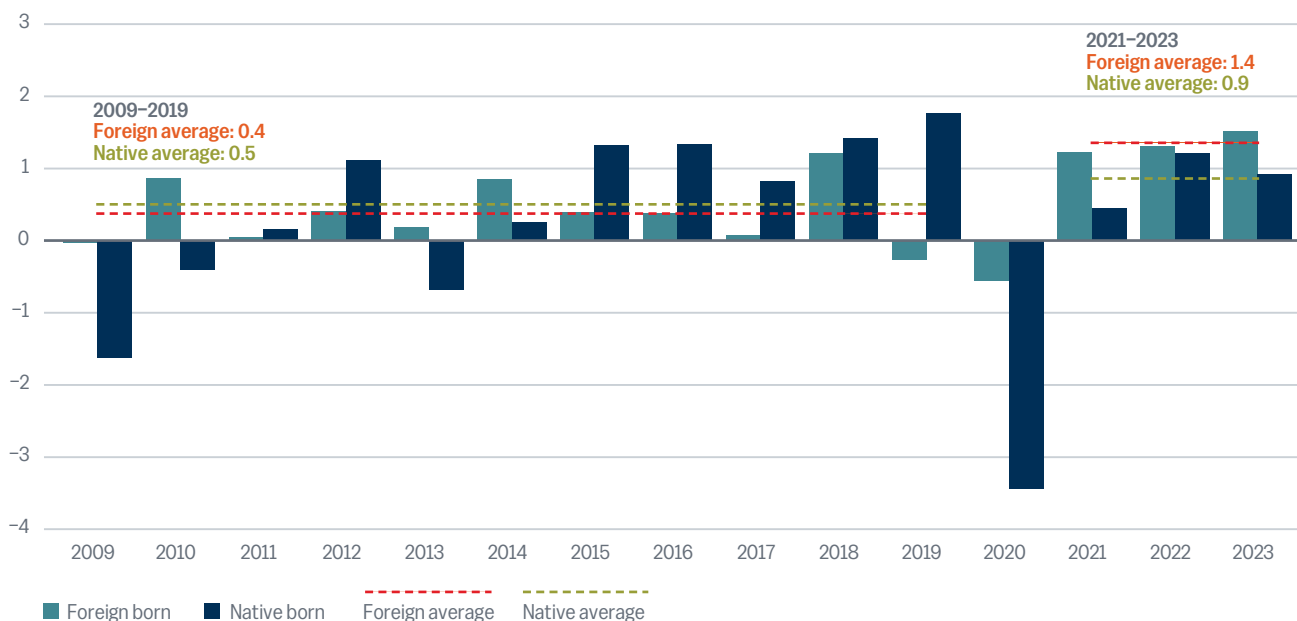
Data as of December 31, 2023.

Sources: U.S. Bureau of Labor Statistics, Wilmington Trust.

Figure 4

Foreign-born workers add more to labor force than native-born

Annual labor force growth by place of birth 2014–2023 (millions)



Mass deportation of illegal immigrants could lead to labor shortages and deprive the economy of immigrants' significant annual spending.



time, especially in sectors where they represented high shares of the workforce: agriculture, leisure, hospitality, household services, and construction.¹⁰

A sudden removal of all illegal immigrants (or even one million per year as estimated by Vice President Vance¹¹) could lead to labor shortages in immigrant-heavy sectors. The current unemployment rate for native-born workers is 4.1% (up from an historic low in 2022–2023), reflecting about 5.5 million people, which is not enough to fill the spots of workers facing deportation.¹²

Moreover, there could be a sharp slowing in economic activity, as prices for associated goods and services provided by illegal immigrants likely would increase. Full deportation also would eliminate illegal immigrants' estimated contributions to economic growth, a projected \$8.9 trillion over the coming 10 years.¹³

The strongest periods of labor-force growth in the past decade saw increases from the native-born population of about one million per year. We believe that mass deportations on the scale proposed could lead, at best, to a stalling of labor-force growth; more likely, the overall labor force would decline. The combination of a shrinking labor force and reduced spending from deportees could lead to a decline in GDP in late 2025 or in 2026, depending on the speed and magnitude of deportations.

Taxes, spending, and deficits: The perennial chute

Our last chute in 2025 is the trajectory of federal deficits, how they are affected by new policies and, critically, the reaction of bond investors. We expect President-elect Trump and the Republican-controlled Congress to move quickly to implement the proposed policies of tariffs, lower taxes, and reduced long-term federal spending. An immediate implementation of all stated policies is a near-term risk to the economy by way of higher interest rates, in our view.

We see two main obstacles to full implementation: the projected impact on deficits and narrow majorities in Congress. If investors believe that policies will increase deficits significantly—which would raise both interest rates and federal interest payments—markets likely would reflect this by driving rates upward, raising the possibility that many members of Congress would be loath to support such policies. Higher rates and tighter financial conditions would, in turn, weigh on the economy in 2025.

While President-elect Trump has asserted that his tax plans would stimulate enough economic growth to ultimately generate fiscal surpluses, most research finds otherwise. Budget-watching think tanks¹⁴ that analyze tax proposals have found that the plans would widen the federal deficit over a 10-year period relative to a baseline of current tax laws and spending. The degree of projected deficit-widening differs depending on how different groups model the economic boost resulting from reduced taxes, with the lowest of those estimates showing that the proposals could add \$2.5 trillion to the deficit over 10 years¹⁵ (Figure 5).

Figure 5

Proposed tax cuts likely to add to federal deficit

Estimated revenue impact of Trump tax proposals over 10 years

Revenue losses	Trillions (\$)
Make TCJA personal tax rates permanent	-\$3.4
Restore full State and Local Tax (SALT) deduction	-\$1.0
TCJA estate tax	-\$0.2
Reinstatement of bonus depreciation and other business deductions	-\$0.6
Exempt Social Security benefits from income tax	-\$1.2
Exempt overtime pay from income tax	-\$0.8
Exempt tips from income tax	-\$0.1
Lower corporate tax rate to 15% for domestic production	-\$0.4
Total	-\$7.7

Revenue gains	Trillions (\$)
Tariffs	\$3.8
Repeal IRA green energy tax credits	\$0.9
Total	\$4.7

Total revenue impact of tax proposals (before dynamic impacts)	-\$3.0
Revenue boost from dynamic impacts of stronger economic growth	\$0.5
Total revenue impact of tax proposals (with dynamic impacts)	-\$2.5

Data as of October 14, 2024.

Sources: Tax Foundation, Wilmington Trust.

The new administration's tax proposals could have a negative impact on the federal deficit. If enacted, bond investors could heavily sell bonds, which likely would raise interest rates.

Extending the TCJA personal income tax rates does not materially affect our baseline expectation for 2025 and would not change taxpayers' current paychecks. As we discussed in our "Economic Ladders" theme, lower business taxes could provide a boost to the economy by stimulating capex.

Turning the proposals into policy, however, requires nearly every Republican member of Congress to get on board, with little room for defections. Republicans will have a six-seat advantage (53–47) and their House majority will be five—far short of the 47-seat advantage Republicans enjoyed when passing the TCJA in 2017. Any concern among moderates about the impact on deficits could make passage more challenging.

We expect financial markets to be the ultimate arbiter of how much can be achieved through the channel of long-term interest rates. The recent experience of 2023 is instructive. In August of that year, Fitch Ratings downgraded the U.S. government's credit rating to AA+ from AAA, due to the deterioration of the nation's long-term finances and the frequent political standoffs of government shutdowns and negotiations to raise the national debt limit.¹⁶ Bond investors were also digesting a much-higher-than-expected borrowing announcement from the U.S. Treasury.¹⁷ These forces pushed the benchmark 10-year Treasury yield upward to 5% by mid-October of that year, which raised borrowing costs for mortgagees and corporate debt issuers alike.

We are keenly aware that President-elect Trump's ambitious tax-cutting agenda could spark a similar reaction in bond markets in 2025, posing a risk to economic growth as well as markets. The Congressional Budget Office (CBO) projects deficits to rise to \$2.9 trillion by 2034 if the TCJA's lower tax rates expire as scheduled. Trump's proposed policies could add a cumulative \$3.0 trillion over 10 years, bringing the annual deficit in 2034 to \$3.3 trillion.¹⁸

The CBO baseline includes \$13 trillion of federal debt service over the 10 years, assuming an interest rate of 4%, but we believe interest rates would move higher. Raising the 10-year yield by just 0.5% (i.e., to 4.5%) over the coming decade would increase the debt service by another \$1.5 trillion, and an additional \$1.5 trillion if rates went to 5%.¹⁹ Markets would likely price in these impacts as the policies are implemented in 2025, which would tighten financial conditions and weigh on economic growth.



Playing the Investment Game



PLAYING THE INVESTMENT GAME

Equity markets hit new all-time highs following the U.S. presidential election, and valuations are elevated¹ across asset classes. This is analogous to arriving at the upper reaches of the Chutes and Ladders game board, which could trigger more anxiety because landing on one of the remaining chutes might entail a greater loss.

As with the game, however, not all chutes are the same length: Some will set you back a few spaces, while others may take you back closer to the start. Importantly, risk goes two ways, and ladders present themselves even at the higher spaces. The only chance to win is to keep playing.

We shared our analysis of the upside and downside risks facing the economy in the year ahead in our “Economic Ladders” and “Mind the Chutes” themes. This section assesses additional chutes and ladders that may not be fully priced into markets today, and concludes that the balance of risks has shifted in the wake of the post-election rally.

Equity valuations reflect a great deal of optimism in markets. While we recognize upside risk for corporate earnings from productivity gains and fairer trade, these dynamics will play out over multiple years. The full balance of risks for the year ahead, though evolving, has convinced us to enter the year with only a very modest overweight to equities.

Valuations: A market chute

Markets tend to be more volatile than the economy, often overshooting in positive times and overcorrecting during slowdowns. One reason for this is investors' tendency to focus on one side of the risk spectrum at a time.

In other words: Over long periods, markets are fairly efficient and do a good job of pricing the balance of risks across the spectrum. However, at any given point, market players typically focus almost exclusively on either upside or downside risks, but not both. This phenomenon, a form of self-perpetuating recency bias, is evident as we enter 2025. The market effectively reincorporates the same positive risks over and over as valuations climb—leaving a lot further to fall when traders and other market participants suddenly flip to embrace only the negatives.

What's priced in?

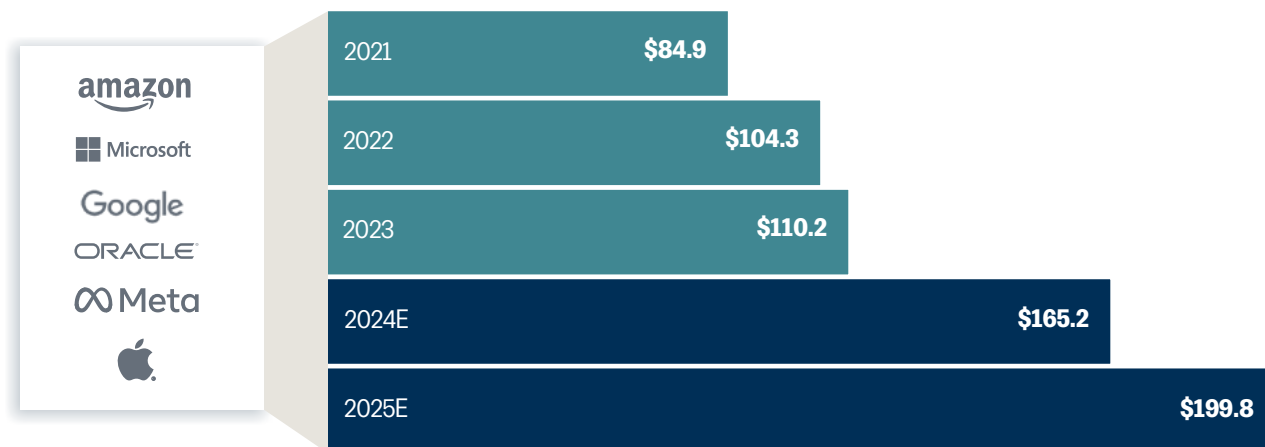
Our take is that since the election, markets have focused on the tall ladders a second Trump term would likely bring (i.e., a favorable tax landscape and a lighter regulatory environment that reinvigorate not only capital spending, but also corporate dealmaking and investment).

We think these two policy platforms, while far from having crystallized and certainly not yet observable in the real economy, are now almost fully priced into equity valuations. Meanwhile, incremental market gains are vulnerable to the downside economic risks in a Trump 2.0 economy. This near-exclusive focus on the upside potential makes equity valuations a key chute that investors must negotiate.

Figure 1

Big Tech spends big in AI race

Big Tech capital expenditures 2021–2025E (\$ billions)



Data as of October 4, 2024.

Source: Bloomberg Intelligence. Represents the capex estimates for Amazon Web Services, Microsoft, Google, Oracle, Meta, and Apple. E = estimate.

Valuation metrics are important tools in determining the balance of risks priced into the market, but they can be complicated. For example, the S&P 500's 2024 calendar-year return exceeded its earnings growth rate by nearly 20%, and valuations are currently at about the 95th percentile relative to the past 25 years of history when considering metrics including the price-to-earnings (P/E) and price-to-cash-flow ratios, and the cyclically adjusted P/E ratio.

We see very little additional juice to be squeezed from valuations given our expectations for monetary policy and interest rates. This means the onus falls on future earnings surpassing current expectations to drive the market meaningfully higher.

Speculating about a tech bubble

Valuations of technology companies, in particular, are causing investor angst. Enthusiasm over AI has resulted in investors paying lofty valuations for shares of technology and interactive media companies (e.g., more than 30 times forward earnings estimates for the “Magnificent 7” tech giants). This, in turn, has driven the overall market earnings multiple to levels observed only a few times in history. It also is drawing comparisons to the late-'90s tech bubble, when a series of catalysts resulted in a violent unwinding of sky-high valuations and ultimately triggered a recession.

There are certainly some similarities to the tech bubble: a palpable fear of missing out, rapid rerating of valuations, and tremendous capital investment from the largest tech companies. AI hyperscalers (i.e., producers) Amazon, Microsoft, Google, Oracle, Meta, and Apple are expected to spend a total of nearly \$200 billion in 2025—almost double their 2022 investment—to expand data centers and create AI-centered software² (Figure 1).

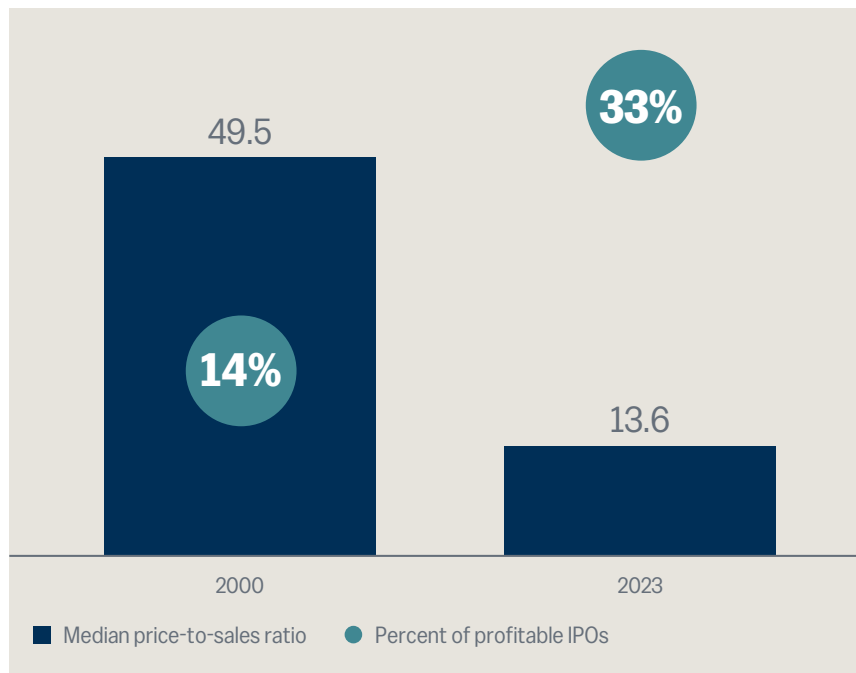
Unlike in the '90s tech bubble, however, today's valuations of AI leaders are underpinned by strong profitability rather than pure speculation. Consider the tech IPO environment then and now. In 2000, the median price-to-sales (P/S) ratio of tech companies going public was an astounding 49.5, and just 14% of those were profitable at the time of listing. In 2023, the median P/S ratio was 13.6, and 33%—more than double the percentage in 2000—had positive earnings³ (Figure 2). Similarly, the tech sector represented 32% of the large-capitalization equity index's market cap in 2000, but only 12% of its earnings. Today those figures are more healthily aligned at about 38% and 33%, respectively.⁴

To add further nuance, recognizing what valuations signify is as important as appreciating what they do *not* signify. Specifically, valuations tell us very little about the prospects for short-term returns. The S&P 500's P/E ratio, for example, has almost no relationship to forward 12-month returns for the equity market. The relationship is much stronger when looking at forward five- or 10-year annualized returns, where we see that higher valuations coincide with lower annualized future returns (Figure 3).

Simply put, investors should mind the risk of elevated valuations in 2025, but valuations can stay elevated for a prolonged period of time. In our view, elevated valuations are not a reason in and of themselves to take an overly conservative stance in portfolios.

Figure 2

Tech IPO environment is much healthier than during late 1990s
Median price-to-sales ratio and percent of IPOs with positive profits



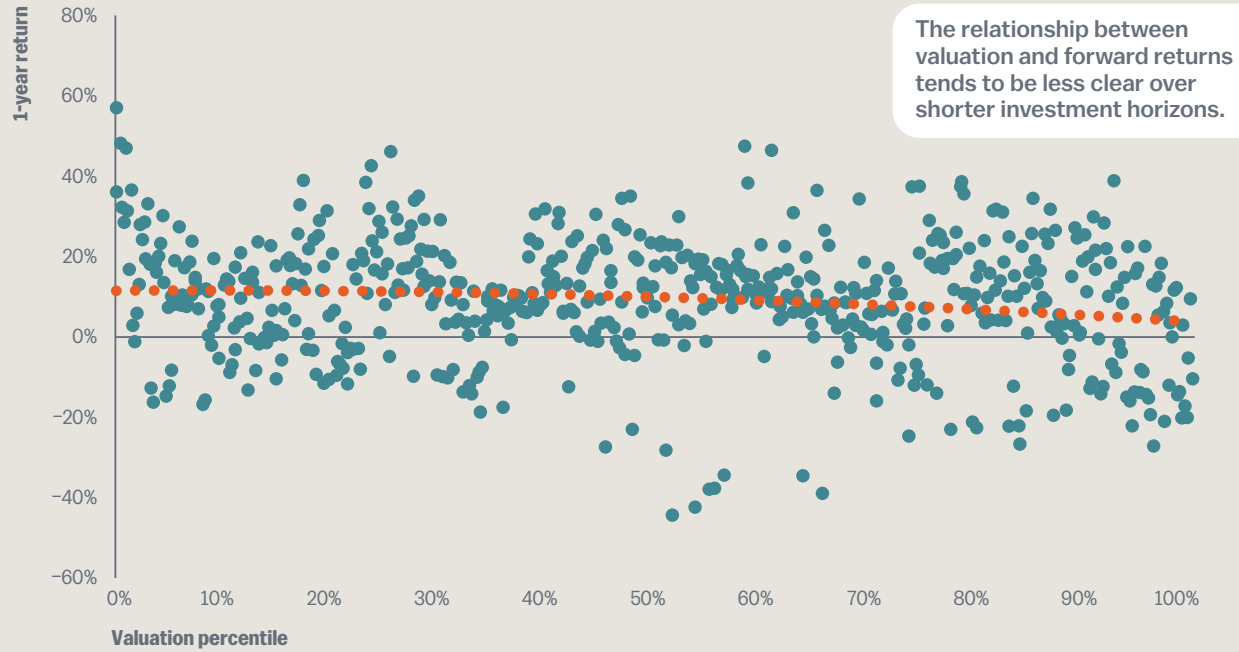
Data as of September 9, 2024.

Source: Jay R. Ritter, Initial Public Offerings: Technology Stock IPOs. University of Florida. Represents valuation (price-to-sales) and profitability data as of the close of the first trading day. A lower figure for price-to-sales indicates a less expensive market. A higher number is better for profitability.

Figure 3

Valuations present a bigger “chute” for long-term equity returns

S&P 500 cyclically adjusted price/earnings ratio and one-year forward return

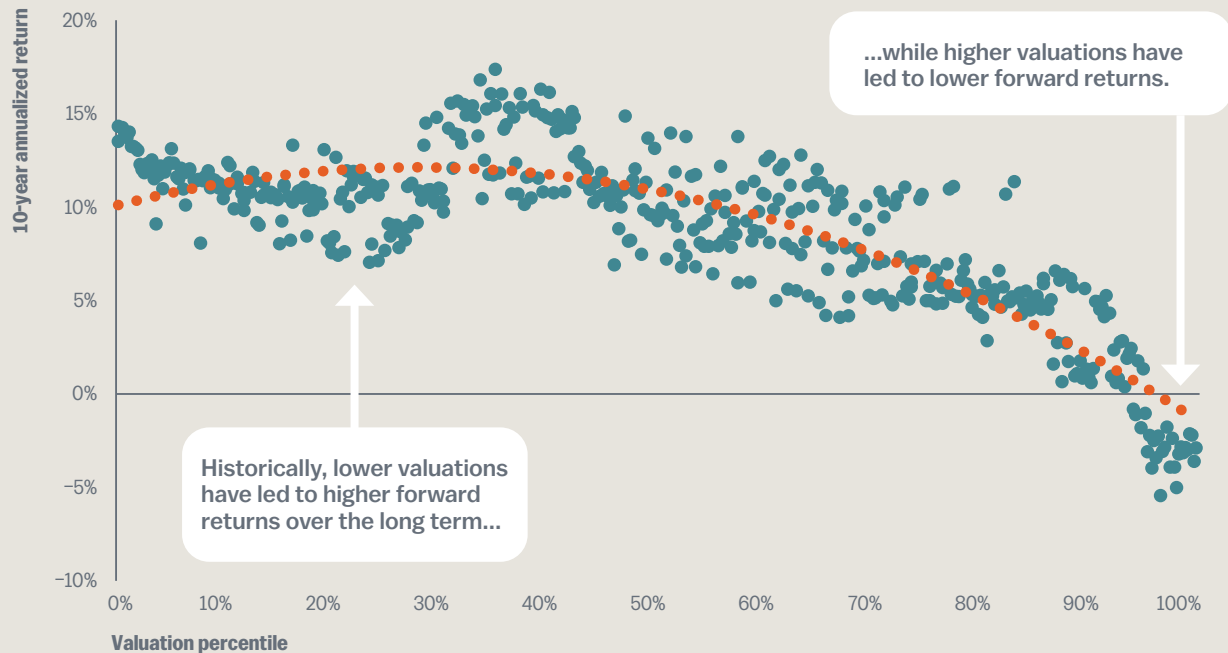


Monthly data collected between December 1975 and December 2023. Percentile is calculated using a fixed window over the entire lookback period.

Chart shows the relationship between valuations and forward-looking returns. The x axis is the percentile rank of the price-to-earnings ratio for the S&P 500 for the dates noted. The y axis is the one-year forward-looking annualized return for the S&P 500 at the given valuation. Orange dots represent a regression to fit the relationship of the data.

Over longer time horizons, valuations have a stronger relationship with forward-looking returns

S&P 500 10-year annualized return



Monthly data collected between December 1975 and December 2014. Percentile is calculated using a fixed window over the entire lookback period.

Chart shows the relationship between valuations and forward-looking returns. The x axis is the percentile rank of the price-to-earnings ratio for the S&P 500 for the dates noted. The y axis is the 10-year forward-looking annualized return for the S&P 500 at the given valuation. Orange dots represent a regression to fit the relationship of the data.

Sources: WTIA, Bloomberg.

Upside market risks

Despite elevated valuations, we see two additional potential ladders that we do not believe are baked into the market. These are 1) lighter regulation that spurs corporate dealmaking and higher productivity across industries, and 2) expanded access to foreign markets in a fairer trade landscape. Each could result in material upside for corporate earnings over a long time horizon and could start to be priced into markets as early as 2025.

Lighter regulation, M&A establish fertile ground for growth of AI

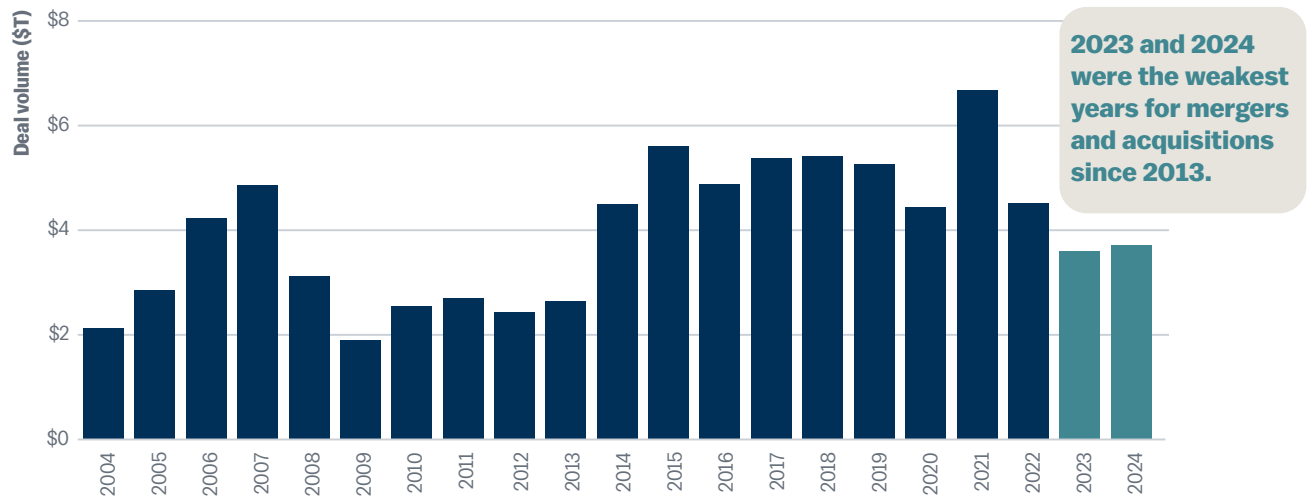
Historically, less regulation has most directly benefited the earnings of companies in highly regulated sectors like financials and energy. Those sectors will likely benefit from the traditional tailwinds of a lighter regulatory landscape of reduced red tape and more tolerance for mergers and acquisitions (M&A) activity—which should encourage investment and the realization of operational synergies. M&A has been depressed due to elevated interest rates and uncertainty around the economy and related policy. In fact, 2023 and 2024 were the lowest years for M&A by dollar volume since 2013 (Figure 4). We expect activity to increase in 2025 as the Fed eases monetary policy and Washington fosters a more favorable dealmaking environment.

A lighter regulatory touch in the Trump 2.0 economy is also arriving at a critical time, given the ascent of AI. Establishing regulation for this new and immensely powerful technology is a challenging (and unenviable) task. We know neither the full scale of AI's capabilities nor what risks it may present down the road. What we can be more certain of is that lighter regulation gives U.S. producers and consumers of AI the best chance of maintaining a competitive edge against the rest of the world in this technology arms race.

Figure 4

M&A activity expected to rebound after weak 2022–2024

Dollar value of mergers and acquisitions 2004–2024 (trillions)



Data as of November 25, 2024.

Source: Bloomberg.

We believe that AI will realize its full productive potential across functions and sectors with additional time, potentially helping the S&P 500 achieve or exceed the 13% earnings growth baked into 2025 consensus analyst estimates.

The beneficiaries of AI-friendly regulation fall into two categories: hyperscalers and deployers. There are obvious upsides to Big Tech (e.g., chip, cloud, and software companies) from a regulatory approach that encourages AI research and investment. These upsides are also well recognized by investors as reflected in valuations, while risks around antitrust regulation loom large.

What we see as less appreciated in the market is the potential for AI—in conjunction with increased M&A—to benefit non-tech AI deployers which, in many cases, are trading at reasonable valuations. The S&P 500 Equal Weight Index, for example, is trading at just a 5% premium to its 10-year historical average P/E, compared to a 20% premium valuation for the market-cap weighted S&P 500.⁵

If regulation strikes the right balance between fostering innovation and protecting safety, health, and security interests, AI can help companies in the health care, defense, auto, and media industries make huge leaps forward in terms of productivity-driven earnings growth.

There are many examples of AI improving corporate profitability across industries, but research suggests that it is still very underutilized in business. The Census Bureau's October 2024 *Business Trends and Outlook Survey* found that just 5% of companies reported using AI to produce goods and services,⁶ and many tasks remain centered on assisting customer service or administrative functions.⁷

Accordingly, we believe that AI will realize its full productive potential across functions and sectors with additional time, potentially helping the S&P 500 achieve or exceed the 13% earnings growth baked into 2025 consensus analyst estimates. It will take many years, though, for the economy and markets to broadly feel AI's impact.

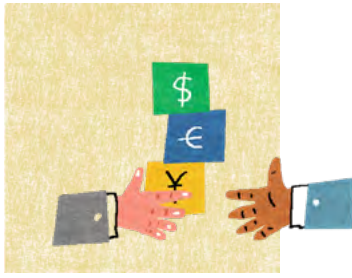
Earnings growth generally tracks economic growth over long periods of time. In the past 22 years, however, the growth rate of S&P 500 earnings has exceeded U.S. nominal (i.e., not adjusted for inflation) GDP growth by an average of 4.5%—meaningfully higher than in the prior three decades, when nominal GDP grew *faster* than corporate earnings.⁸ This can be attributed to globalization, lower taxes, and tech-driven productivity elevating real wages.

We believe AI-related productivity could sustain, or even increase, the positive differential between earnings growth and GDP over the next decade.

Tariffs as a tailwind?

Wall Street almost universally regards tariffs as posing a significant negative risk to equities. We don't disagree, especially in the short term and if carried out at the scale discussed on the campaign trail.

But we are long-term investors. It may not be easy to see today, and it may not be possible to achieve using tariffs, but a fairer, more-open trade environment that increases U.S. companies' revenue base and earnings potential could be a potentially underappreciated ladder for U.S. markets.



Any leveling of the playing field that opens China's market could benefit U.S. industrial or consumer discretionary companies, while continued trends of onshoring or "friendshoring" could benefit the ailing manufacturing sector.

From a market perspective, it is challenging to find many short-term beneficiaries of broad-based tariffs against China or other trading partners, given the webs of interconnectivity that global supply chains are. Tariffs of the nature discussed by President-elect Trump could penalize any companies importing intermediate or final goods, depending on how the tariffs are structured.

Even the smallest companies that generate most of their revenue domestically are likely to have some supply-chain exposure to China. These companies may have less supply-chain redundancy, making it harder to quickly adjust to tariffs. Larger, publicly traded companies are even more prone to sourcing a significant amount of intermediate goods from outside the U.S., though many of the more exposed companies have shifted or diversified supply-chain exposure since the first Trump administration.

Depending on the degree to which tariffs include consumer-facing goods, we see consumer discretionary and tech companies—the latter are very exposed to retaliatory tariffs—as most vulnerable to downside risks in the short term.

What is much less discussed in the financial realm are the potential long-term benefits to U.S. companies from fairer trade terms that provide increased access to foreign markets. To be clear, this is a potential long-term benefit that is more difficult to quantify, could come at the cost of short-term price increases and market volatility, and requires a time horizon longer than many market participants are willing to assume. But the earnings upside could be significant, in our view.

Full and unfettered access to China's 1.4 billion consumers would represent a potential windfall for many multinational companies. However, China remains the biggest violator of global fair-trade standards, and is known for its subsidies to domestic companies and unfair intellectual property practices that destroy the earnings moats of U.S. companies.⁹

It is unclear whether any strategy—tariffs included—would result in a material opening of the Chinese market at this point. Not only are the competitive tensions between the U.S. and China higher than at any time since China joined the World Trade Organization in 2000, but there also are more significant national security concerns today that limit unrestricted trade of technology. Any leveling of the playing field that opens China's market could benefit U.S. industrial or consumer discretionary companies, while continued trends of onshoring or "friendshoring" could benefit the ailing manufacturing sector.

Another potential source of upside for U.S. corporate earnings comes from addressing less obvious, nontariff barriers among the U.S. and other trade partners. These include requirements for health, safety, or packaging, and can impede U.S. companies' ability to sell into foreign markets or force the companies to incur additional costs of compliance with varying standards.



In a chutes and ladders economy, the investment landscape potentially is exposed to higher highs and lower lows. An extended period of strong returns and low volatility thus means that U.S. equity returns could be more muted and volatile in 2025.

These barriers are recognized on a bipartisan basis and affect many different industries. In fact, the Office of the U.S. Trade Representative under President Biden noted “significant foreign trade barriers in 59 markets” impeding U.S. corporations’ ability to sell everything from agricultural products to autos.¹⁰ Relaxation of these barriers could reduce costs and improve revenue potential for providers of pharmaceuticals, packaged foods, autos, and technology.

Building resilient portfolios

A chutes and ladders economy means an investment landscape that is subject to the possibilities of higher highs and lower lows. Volatility was noticeably absent in 2024 but is still a part of investing, particularly when it comes to equities, the historical engine of portfolio growth. An extended period of low volatility and remarkable returns—more than 20% for the S&P 500 in four out of the past six years—means performance of U.S. equities could be more muted, and volatility higher, in 2025.

This notion, understandably, makes many investors nervous and perhaps more willing to hold elevated levels of cash while awaiting the next pullback. However, sitting out the market and missing out on the power of compounding—an impressive 10.7% average annualized return for the S&P 500 over the past 50 years¹¹—has historically been an irreparable mistake.

Our philosophy is that the market’s tendency to focus on one side of the risk spectrum and the resultant short-term volatility makes market timing simply too hard and, therefore, big bets on portfolio positioning too risky. Instead, our economics-led process focuses on keeping portfolios close to their long-term asset allocation targets unless we can clearly see the likelihood of a drawdown that could be deep and long enough to significantly impair a portfolio’s long-term growth.

Such drawdowns almost always have occurred in or around recessions. In the past 75 years, the S&P 500 has had 14 drawdowns of at least 15%. Six of those took place outside of a recession, though nonrecessionary market corrections tend to be shallower and shorter-lived than those occurring during a recession.

Nonrecessionary drawdowns in the past 75 years have averaged about 25%, versus 37% for those in or around a recession. Perhaps more important for long-term investors is that nonrecessionary drawdowns have recovered—i.e., reclaimed their pre-drawdown peaks—nearly 40% faster on average than recessionary pullbacks (Figure 5). For most investors, their investment horizon is long enough that the benefits of staying in the market outweigh the short-term risks.

A constructive outlook

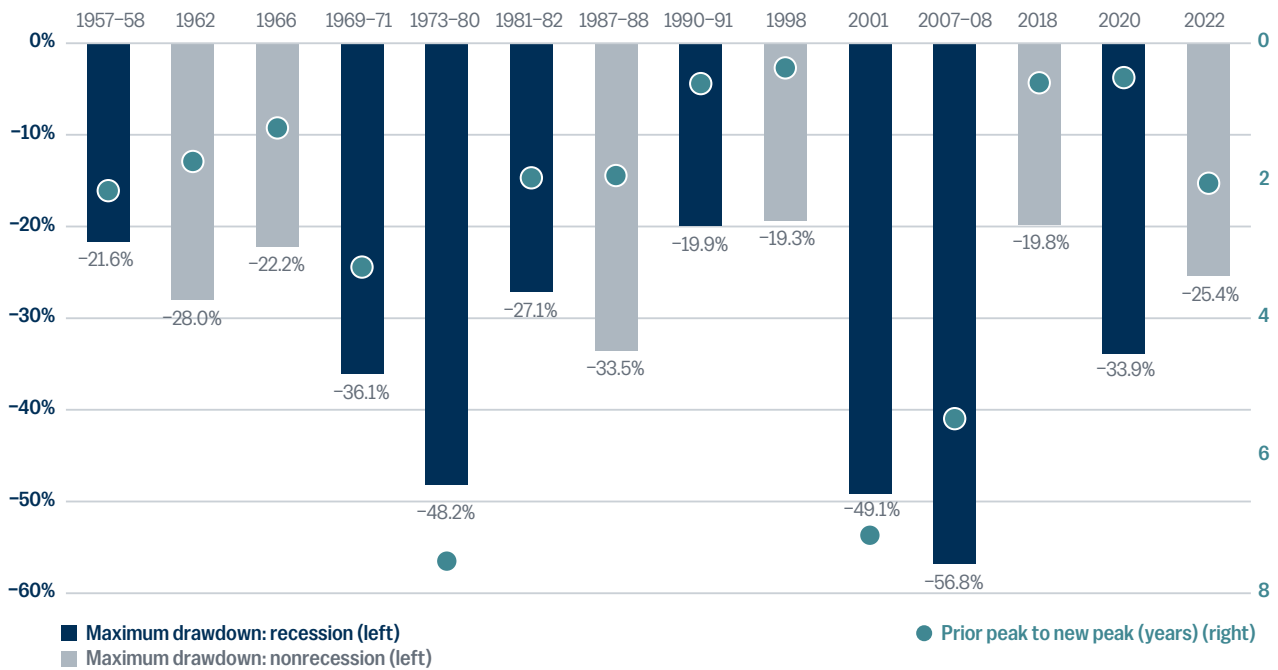
We enter 2025 recognizing two-way risks, yet remain constructive on the direction of the economy and markets. Our base case is for continued U.S. economic growth but more modest equity returns. Higher volatility could reappear, but we do not expect it to derail the bull market.

There will undoubtedly be twists and turns as the year unfolds and the details of President-elect Trump's policy strategy take shape. As those details become clearer, our reliance on rigorous analysis of the economy and markets—rather than a roll of the dice—will guide our game plan for investing our clients' capital.

Figure 5

There have been 14 serious drawdowns since 1950

S&P 500 peak-to-trough drawdowns of more than 15% since 1950, with years to recover to prior peak



Data as of October 12, 2022.

Sources: Bloomberg, WTIA. Bars represent drawdowns of more than 15% for the S&P 500. Data collected from 1950 to present.

Gray bars represent nonrecessionary periods while orange bars represent recessions as defined by National Bureau of Economic Research classifications.

The blue dots represent the duration (in years) to reach the prior peak level for the index.

APPENDIX

ENDNOTES

Economic Ladders (pages 4–9)

- ¹ National Bureau of Economic Analysis as of December 1, 2024. Growth for full-year 2024 is an estimation.
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- ³ Gabriel Chodorow-Reich, et al., *Tax Policy and Investment in a Global Economy*, National Bureau of Economic Research, March 2024.
- ⁴ Bureau of Economic Analysis, WTIA.
- ⁵ “Trump announces Musk, Ramaswamy will lead newly-created Department of Government Efficiency,” CBS News, December 5, 2024.
- ⁶ *Fiscal Sanity to Save America*, Republican Study Committee, March 20, 2024.
- ⁷ *2024 Republican Party Platform*, The American Presidency Project, July 8, 2024.
- ⁸ *IBID.*
- ⁹ Congressional Budget Office (historical data), Wilmington Trust (calculations).

Mind the Chutes (pages 10–17)

- ¹ “Trump ups the ante on tariffs, vowing massive taxes on goods from Mexico, Canada and China on Day 1,” CNN, November 26, 2024.
- ² *IBID.*
- ³ The equity market correction was not entirely due to tariffs and the economic impact. Investors also were concerned at the time about tightening of monetary policy.
- ⁴ “Protectionism in the Interwar Period,” U.S. Department of State Office of the Historian.
- ⁵ Flora Haberkorn, et al., “Global trade patterns in the wake of the 2018-2019 U.S.-China tariff hikes,” FEDS Notes, April 12, 2024.
- ⁶ *Fiscal, Macroeconomic, and Price Estimates of Tariffs Under Both Non-Retaliation and Retaliation Scenarios*, The Budget Lab, October 16, 2024.
- ⁷ Erica York, et al., “Donald Trump Tax Plan Ideas: Details and Analysis,” Tax Foundation, October 14, 2024.
- ⁸ Jeffrey S. Passel and Jens Manuel Krogstad, “What we know about unauthorized immigrants living in the U.S.,” Pew Research Center, July 22, 2024.
- ⁹ These figures on foreign-born workers do not distinguish by legal status.
- ¹⁰ Jeffrey Passel and D’Vera Cohn, “Industries of unauthorized immigrant workers,” Pew Research Center, November 3, 2016.
- ¹¹ “Inside Trump’s plan for mass deportations—and who wants to stop him,” Reuters, November 10, 2024.
- ¹² U.S. Bureau of Labor Statistics, Wilmington Trust.
- ¹³ Ted Hesson and Kristina Cooke, *Effects of the Immigration Surge on the Federal Budget and the Economy*, Congressional Budget Office, July 2024.
- ¹⁴ These include the Tax Foundation, Yale Budget Lab, and the Committee for a Responsible Federal Budget.

- ¹⁵ “Donald Trump Tax Plan Ideas: Details and Analysis,” Tax Foundation, October 14, 2024.
- ¹⁶ “Markets Still Contemplating the Implications of a U.S. Credit Rating Downgrade,” Wilmington Trust, August 7, 2023.
- ¹⁷ “US Ramps Up Debt Issuance, Adding Fuel to Selloff in Treasuries,” Bloomberg, August 2, 2023.
- ¹⁸ *Congressional Budget Office.*
- ¹⁹ “How Changes in Revenues and Outlays Would Affect Debt Service, Deficits, and Debt,” Congressional Budget Office interactive workbook, October 29, 2024.

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- ¹ As of December 5, 2024.
- ² “Big tech 2025 capex may hit \$200 billion as gen-AI demand booms,” Bloomberg, October 4, 2024.
- ³ As of the close of the first trading day. Source: Jay R. Ritter, *Initial Public Offerings: Updated Statistics*, University of Florida, September 9, 2024.
- ⁴ *Portfolio Strategy Report*, Empirical Research Partners, October 7, 2024.
- ⁵ Bloomberg as of October 31, 2024.
- ⁶ *Business Trends and Outlook Survey, BTOS* – Data, U.S. Census Bureau, November 7, 2024.
- ⁷ Jennifer Torres, “Can Generative AI Boost Productivity, Attitude of Customer Service Agents?,” CMSWire, June 14, 2023.
- ⁸ *Portfolio Strategy Report*, Empirical Research Partners, November 2024.
- ⁹ “The Contentious U.S.-China Trade Relationship,” Council on Foreign Relations, May 14, 2024.
- ¹⁰ “USTR Releases 2024 National Trade Estimate Report on Foreign Trade Barriers,” Office of the United States Trade Representative, March 29, 2024.
- ¹¹ Bloomberg. Represents the average annualized total return of the S&P 500 over the past 50 years, as of November 30, 2024.

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APPENDIX

DEFINITIONS

Capital expenditures (capex) is the money an organization or corporate entity spends to buy, maintain, or improve its fixed assets, such as buildings, vehicles, equipment, or land.

Cyclically adjusted price-to-earnings (CAPE) ratio is a valuation metric used to assess a company's or the market's long-term financial performance.

Drawdown is a peak-to-trough decline during a specific period, quoted as the percentage between the peak and the subsequent trough.

Earnings multiples are used to quantify a company's growth, productivity, and efficiency, and make comparisons among companies in an effort to find attractive investment opportunities. A multiple may, for example, be used to show how much investors are willing to pay per dollar of earnings, as computed by the price-to-earnings (P/E) ratio.

Effective tariff rate is a weighted-average tariff rate that accounts for the tariff applied to the finished product and imported inputs.

Fitch Ratings is a credit rating agency that rates the viability of investments relative to the likelihood that the issuer will default. Fitch is one of the top three credit rating agencies internationally, along with Moody's and Standard & Poor's.

Large-cap stocks are those from a public company whose total market value, or market capitalization value, is more than \$10 billion. They are generally considered less risky than small-cap stocks.

Market capitalization (market cap) is the value of a company traded on the stock market, calculated by multiplying the total number of shares by the present share price.

Price-to-cash flow (P/CF) ratio compares a company's current market value to its operating cash flow. A lower P/CF indicates a potentially undervalued stock, while a higher ratio might suggest overvaluation.

Price-to-earnings (P/E) ratio measures a company's current share price relative to its earnings per share (EPS).

Price-to-sales (P/S) ratio measures the value that investors place on the company in comparison to the total revenue generated by the business; calculated by dividing the share price by the sales per share.

S&P 500 index is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the U.S. It is one of the most commonly followed equity indices.

S&P 500® Equal Weight Index (EWI) is the equal-weight version of the widely used S&P 500 and includes the same constituents as the S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight, or 0.2% of the index total at each quarterly rebalance.

Small-cap stocks are those from a public company whose total market value, or market capitalization, is about \$250 million to \$2 billion. Small-cap stocks are generally considered riskier and more prone to wide market fluctuations than large-cap stocks.

Stagflation is persistent high inflation combined with high unemployment and stagnant demand in a country's economy.



From left: Meghan Shue, Tony Roth, Luke Tilley

PRINCIPAL AUTHORS

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Chief Investment Officer

Tony develops and delivers investment services for our wealth and institutional clients. He leads the strategic direction for the firm's asset management investment activities, including asset allocation, manager research, and portfolio construction. Tony heads the firm's Investment Committee and hosts the award-winning podcast *Capital Considerations with Tony Roth*.

Meghan Shue

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Meghan oversees Wilmington Trust's portfolio construction process—implementing a variety of asset class views through proprietary, non-proprietary, passive, active, and factor-based solutions. She is a regular CNBC contributor and is frequently quoted in financial media communicating the firm's economic and market views.

Luke Tilley

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