The ADVISOR

Focus on Community Banking Issues

First Quarter 2025

ECONOMIC ENVIRONMENT

Full Steam Ahead

The U.S. economy ended the year on a strong note, with GDP growth, employment, consumer spending, and business sentiment picking up following worries of a slowdown over the summer. Last quarter, we posed the question of whether September's 50 basis point rate cut was too aggressive, a concern validated by recent data and shifting market expectations. Inflation remains stickier than the Fed would like, and the Trump Administration's growth agenda could push consumer prices higher once again. These dynamics were enough ammunition to shift the FOMC's tone from dovish to hawkish, as evidenced by the removal of two 2025 cuts in the December dot plot and recent commentary from Fed officials. The subsequent upward movement in long term rates illustrates the shift in investor sentiment towards the expectation of less accommodative monetary policy in 2025. In our view, the Fed will continue to enact proactive rate cuts this year, albeit at a slower pace, but inflationary fiscal policy and a decreased likelihood of recession support a higher terminal rate than previously anticipated.

Inflation & Fiscal Policy

A quarter ago, most measures of inflation showed a sustained downward trend, and the 2% target appeared within reach. Since September, however, headline CPI has risen in three consecutive months, fueling concerns that the Fed may have eased prematurely. Consumers continue to spend above trend, while the disinflationary tailwinds from supply chain normalization have largely subsided. So, why did markets react favorably to December's 2.9% annualized rate? Core CPI finally surprised to the downside after months of stalling, with fewer categories experiencing annualized inflation greater than 4%, according to Bloomberg Economics. Moreover, the headline CPI increase was mostly driven by energy, while core goods inflation declined.

Tariffs are the wild card, which could create higher consumer prices if businesses stop importing the targeted products or simply pass the increased costs along to customers. Additional

EPG RATE FORECAST

January 2025

MARKET RATE	Actual (%) 12/31/2024	Projected (%) 12/31/2025	Yr1 Δ	Projected (%) 12/31/2026	Yr2 Δ
FedFunds	4.50	3.75	-0.75	3.75	0.00
Prime	7.50	6.75	-0.75	6.75	0.00
3mthTsy	4.31	3.65	-0.66	3.75	0.10
6mthTsy	4.27	3.60	-0.67	3.75	0.15
1yrTsy	4.14	3.60	-0.54	3.80	0.20
2yrTsy	4.24	3.65	-0.59	3.85	0.20
3yrTsy	4.27	3.65	-0.62	3.90	0.25
5yrTsy	4.38	3.70	-0.68	3.95	0.25
10yrTsy	4.57	3.75	-0.82	4.00	0.25
30yrTsy	4.78	3.85	-0.93	4.10	0.25

RATE OUTLOOK DESCRIPTION:

This represents EPG's current view of interest rates.
Depending on the actual timing of the ALM meeting, the forecast may be altered and/or updated.
For the most accurate current rate outlook, please call EPG, Inc. at (781) 235-2666.

Features

Economic Environment: The economy may be too strong for significant Fed action.

Fixed Income Strategy: A welcome change to the shape of the Yield Curve.

Equity Strategy: Equity investing outlook for 2025.

ALM Strategy: An improved operating environment in 2025.

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ECONOMIC ENVIRONMENT

loosening of fiscal policy, such as an expansion of the 2017 Tax Cuts and Jobs Act, could contribute to price pressures, but would likely boost consumption and savings as well. Wells Fargo expects new tax cuts for U.S. households totaling approximately $100 billion per year to be enacted later in 2025. Given the complexities of the current environment, closely monitoring the trends and underlying drivers of inflation will be crucial in assessing the future path of interest rates and the broader economy.

EPG Rate Forecast: Hit the Slopes

Following 100 basis points of cuts in 2024, the Fed is once again at a crossroads. After the FOMC responded aggressively to last summer's weakening employment picture, the improvement in economic data and potential levying of tariffs present a policy challenge. Many economists harbor concerns that higher tariffs could both increase inflation and slow real GDP growth, as higher prices would offset real income growth, thus weighing on consumer spending. If the Fed responds to rising inflation with rate hikes, unemployment could rise, causing spending to slow even further. However, if the Fed enacts more accommodative policy to offset the slowing effects of tariffs, inflation could push even higher. We project the FOMC will cut rates by 75 basis points total this year, followed by an extended pause that maintains a 3.75% terminal rate throughout 2026. However, we anticipate the pace will be much more spread out than the rapid end-of-year cuts. We should gain greater understanding of the Trump Administration's policy choices and their effects over the coming months, so we expect the Fed to be on hold until the March FOMC meeting. Fed funds futures now imply only a 70% probability of two 25 basis point cuts this year (terminal rate of about 4.00%) and have priced out a full cut since the end of November.

On a brighter note, the yield curve has finally normalized somewhat, with positive slope from the 1-year to 10-year part of the curve. So, why has the curve normalized, and will it remain? Historically, curve steepening is usually driven by the short end through rapid rate cuts. This time, it was caused by long term yields rising faster than short and intermediate term yields, a rare phenomenon known as "bear steepening." Fears of rising inflation seem to be the catalyst at play, as inflation-linked Treasury yields have risen in tandem with the long end. Additionally, the budget deficit is likely to expand further, which has contributed to higher yields via an expected increase in Treasury issuance. In our view, this curve shape may hold until there is greater clarity regarding inflation. However, we expect a flat to normalized curve through 2026 due to gradual, albeit slower cuts, in combination with continued economic strength.

Encouraging Holiday Spending Highlights Consumer Strength

Like clockwork, American consumers continued to spend at elevated levels through the holiday season. New data from the Commerce Department showed 4% year-over-year core retail sales growth across November and December, above the National Retail Federation's 2.5% to 3.5% estimate. This represents a record $994.1 billion in holiday spending, underscoring the level of consumer strength that has driven the ongoing economic expansion. Once again, we ask, are these consumption trends sustainable? To make an assessment, we can examine the relationship between wage growth and inflation in the chart on the next page.

Over the past two years, the combination of declining inflation and steady nominal wage gains has supported real income growth, putting more money into the pockets of Americans. This spread has narrowed because of the recent upticks in inflation but remains at a level that supports elevated discretionary spending. Although today's environment is sturdy, the outlook hinges on the delicate relationship between the labor market and consumer

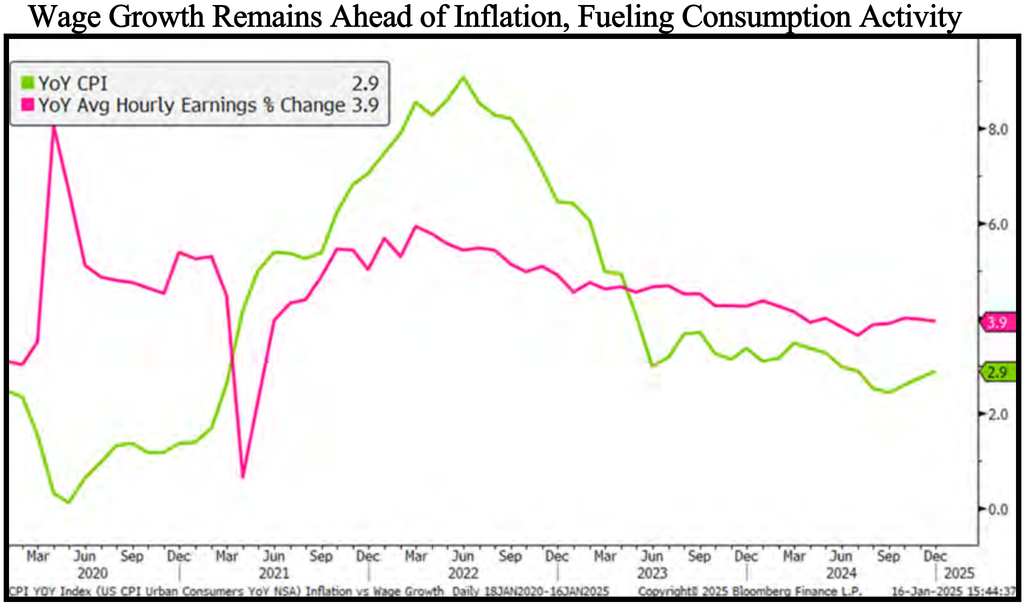
confidence, while outside factors such as tariff-driven price increases threaten to disrupt this balance. Overall, we expect a sturdy consumer base to remain the primary driver of GDP growth this year, with inflation presenting the largest risk.

Labor Market: Stability is Good

Throughout the summer, concerns mounted about the labor market being on the brink of a sharp deterioration, but the past three months of employment data (170K average payroll gains) provide evidence that the job market remains on solid footing. In spite of recent strikes and natural disasters, December's nonfarm payroll report and corresponding drop in the unemployment rate to 4.1% trounced expectations, further supporting a view that additional labor market cooling is likely to be gradual. Many economists expect payroll growth to moderate this year, but due to lower growth in the labor supply rather than mass job cuts.

Although recent payroll gains suggest a reacceleration in hiring, consistent downward revisions to prior months allude to a stabilization of the summer's drop-off. Furthermore, the quits rate continues to trend downward, indicating that workers are slightly less confident in finding a new job. Stabilization of labor market conditions is still a positive trend in our opinion, as fears of a near-term recession have dissipated without the inflationary pressures from skyrocketing wage growth. ◆

Wage Growth Remains Ahead of Inflation, Fueling Consumption Activity



Source: Bloomberg

FIXED INCOME STRATEGY

FIXED INCOME STRATEGY

2024 brought 100 basis points of rate cuts, 2025 looks to have less policy action

The year ahead looks to be a balancing act for the Federal Reserve, as Fed officials continue with their attempt to navigate a soft landing while implementing interest rate cuts. Based on today's economic strength, rate cuts will likely be implemented at a slower pace than originally anticipated. Markets were surprised back in September when the Fed slashed short term rates by 50 basis points rather than a traditional 25 point cut to begin the easing cycle. Many economists thought it was a catch up from not cutting in July or an attempt to avoid policy action during the election. At the time, the forward market was calling for continued easing in 2025 and 2026. However, the combination of above target inflation, contained unemployment, and uncertainty on tariff impacts have quickly altered market sentiment and will likely lead to prolonged interest rate volatility. Fed officials have been wrestling with containing the tail end of elevated inflation in the face of a new administration, and as a result, the December dot plot showed FOMC voting members signaled a slower pace of rate cuts in 2025.

The December employment report added confirmation that the U.S. economy remains strong and supports a less aggressive approach to monetary policy in 2025. The Investment Committee interprets the combination of the FOMC's outlook change and the latest payroll update in a hawkish manner until there is more clarity on tariff implementation. Although fewer rate cuts may be on the table in 2025, we maintain the view that the easing cycle will continue and interest rates will drift lower. The forward markets have consistently been a poor indicator of the future path of interest rates. During the tightening cycle in 2022-2023 the long end of the Treasury curve was quick to price in a recession and the yield curve remained inverted for an extended time. In reality, the probability of a near-term recession remains low today with a consumer that continues to spend and a healthy employment picture.

Early in 2024, the futures market was projecting as many as seven interest rate cuts for the year, again only to be surprised by a stronger than expected U.S. economy resulting in less monetary policy action. As we enter 2025, the economy remains strong and after a blockbuster December employment report with a declining unemployment rate, interest rates will likely remain near the higher end of their recent trading range until there is more clarity on the direction of inflation. Fed officials have commented on the likelihood of less policy action ahead, which would help guide inflation towards the desired target level of 2.0%.

In recent comments, several voting members have offered predictions on containing inflation, maintaining job growth, and continued economic expansion. As a result, policy makers are likely back to a data dependent approach, and even among Fed officials varying opinions about the economy could foster continued volatility. Michelle Bowman recently suggested the Fed is in a "recalibration phase" and that investors should consider interest rates on hold in the near term. Additionally, the strong economic results and fears of the Republican tariff impact has reduced fixed income purchasing activity over the last few weeks, adding to the upward rate pressure across the yield curve. The recent abundant Treasury auction supply has also not been met with sufficient demand from the institutional community. Markets will likely settle down after the presidential inauguration, when investors can hopefully achieve greater clarity to the impact of economic policy changes. Regardless, the yield curve has normalized with "positive slope," just not in the way most economists anticipated when the easing cycle began. That said, mortgage loan rates are higher and investment yields have become attractive (funding adjusted) after 100 basis points of easing and longer term rates drifting higher.

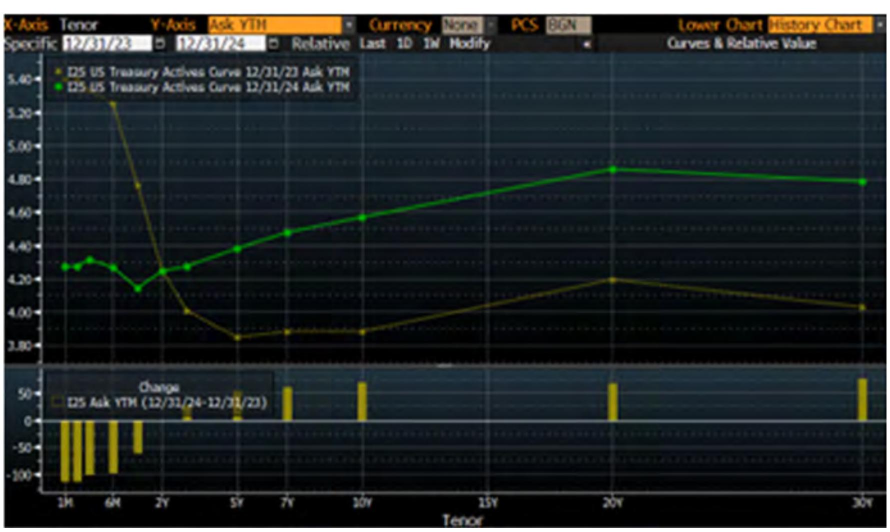
Now, spreads have become positive across the majority of the yield curve, which is a long way from where we were just a few months ago, even if the Fed is slow to make further policy changes.

While loan demand may be light, take advantage of investment opportunities

Limited housing inventory and elevated mortgage rates will continue to prevent prepayments from accelerating in the near term. In fact, even a 100-basis point decline in mortgage rates would not likely be enough to significantly impact borrower behavior. With the mortgage market currently comprised of mostly lower yielding loans (only about 15% of the outstanding agency market has a mortgage rate above 5.0%), a significant decline in rates would be needed to create a material impact on prepayment speeds.

Investment yields across the curve are near the higher end of the recent trading range. Agency CMO floaters continue to look attractive at the current spread of about 150 basis points above SOFR. Although Treasury yields have risen and the bullet structure may be desirable, absolute yield levels remain below other alternatives such as Callable Agencies and Agency MBS, but must be judged in the context of the differences in risk profile driven by call and prepayment risk. Corporate and Municipal markets continue to indicate a reduced likelihood of a recession as spreads remain on the lower end of historical averages, reducing opportunities to enhance yields. Corporations have responded to tight spreads, issuing approximately $80 billion of investment grade securities to begin the year. In comparison, the average new corporate issuance between 2022-2024 for the same time period was $66 billion. ◆

Yield Curve Dec 2023– Dec 2024



Yield Curve Changes 2024

Term	12/31/2023	12/31/2024	Change
2 Year	4.25	4.25	0.00
3 Year	4.00	4.27	0.27
5 Year	3.85	4.38	0.53
7 Year	3.88	4.48	0.60
10 Year	3.88	4.57	0.69
20 Year	4.19	4.86	0.67
30 Year	4.03	4.78	0.75

EQUITY STRATEGY

Equity Investing: Looking into 2025

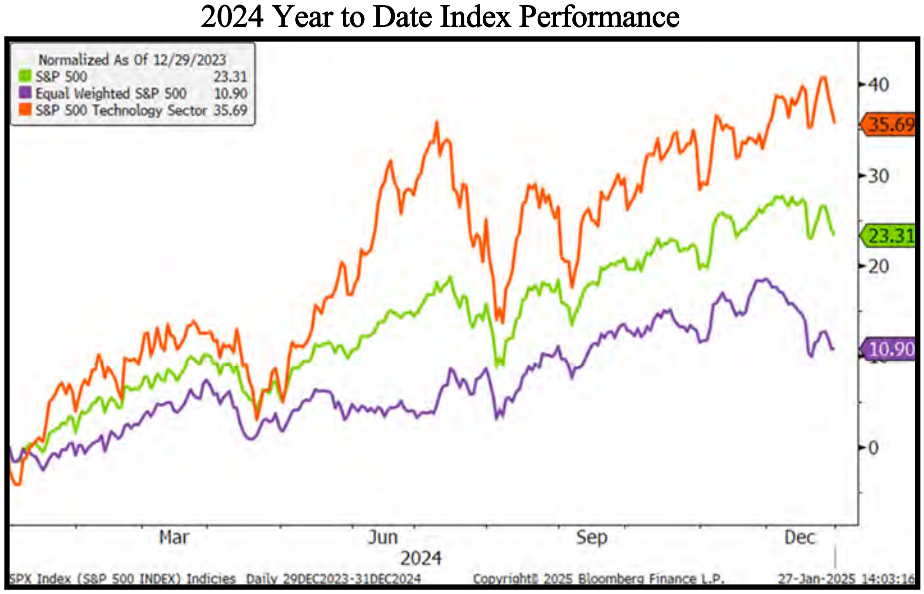
Since October of 2023, optimism that inflation had peaked and that the Federal Reserve would pivot from a stance of rate hikes and maintenance to one of rate cuts has formed a platform for equity appreciation. The S&P 500's rise in 2024 was one of the strongest in recent memory. Positive equity investor expectations for 2025 are being based upon the assumption that the U.S. will continue to be a primary driver for global economic growth, which reflects an expanding business cycle, a stable economy, strong corporate profits, and a healthy labor market. In addition, from the equity investor's standpoint, those companies that continue to lead robust AI-related spending should begin to see results in the coming several years. However, the newness of the AI reality has rightly started conversation around whether the potential risks that an overly optimistic view of the technology and fear of being left behind as investors, is creating what could be the next "internet bubble" experience. The likely environment for 2025 continues to be viewed as also incorporating a down rate environment, albeit more muted than believed even several months back. In addition, a renewed investor focus on economic fundamentals and potential Fed action is seen as an assumption that will impact economic activity and related equity market performance.

Consumer spending and housing affordability are two potentially challenging areas for continued economic momentum. In 2024, consumer spending was focused on services, and the more balanced spending between goods and services in 2025, if actualized, will be a positive development. Also, housing affordability issues and lack of turnover/ inventory may be a potential and continued drag on economic activity in 2025. Equity investors continue to look to interest rate cuts in 2025 as an important stimulus for future economic growth.

Diversify versus Divest:

In 2024, a significant portion of equity returns came from "valuation expansion." This occurs when the market assigns a higher multiple to a company's earnings, cashflow or other metric. Thus, as a company reports the metric, the market gives it more credit for such, and the stock price reflects this growing optimism. P/E ratios are an example of such valuation expansion, and at an index level, the S&P 500 12-month forward P/E is well above its previous 20 year high. This is due in part to mega-cap tech companies, but even without, markets are trading close to record valuations. With this being said, company fundamentals and growing confidence in a

2024 Year to Date Index Performance



EQUITY STRATEGY

strong economy can support stretched valuations. With these elevated equity valuations, investors must ultimately see returns that are driven by earnings growth. Thus, taking into account all of these various elements, many analysts are forecasting 5-10% possible returns for 2025. Concentrations are high in equity market sectors and names within those sectors. Given the potential volatility that could arise if any of the drivers contributing to the stable economic growth show weakness, diversifying holdings within the more heavily weighted sectors, versus divesting away from exposure can make sense.

Large cap companies are likely to maintain leadership as they can apply abundant free cash flow to operate effectively, produce profit margin, and reinvest in operations. Thus, expanding the base of quality names within a sector upon which investment dollars are allocated versus divesting to reduce exposure, can make sense.

Risks to positive equity market performance in 2025:

With the investor optimism that was created by a Republican/Trump sweep evidencing itself in market momentum, one potential risk is that all the positive outlook for the markets is already fully loaded into current valuations. Any disappointments or global events that create competition or market disruption could make equities vulnerable to a short term correction. This could be argued as a risk not so much for the general markets, but rather individual sectors and in particular, individual names. An example of a possible disruptive event or trend could be actual application of tariffs against trade partners versus being used as a negotiating tool. Bond yields that do not decline or worse, rise, could also negatively impact investor sentiment around equities.

Profit growth must support valuations going forward, and fundamental analysis will reflect this. Positive investor expectation based on more macro actions such as rate cuts, election results and other events are unlikely to be sufficient to lift and propel equity valuations. With equity valuations being full, profit growth possibly moderating, and with markets that are highly concentrated, shorter- term volatility is now more likely compared to late 2024.

Equity investment strategy for 2025:

Broader participation within the various sectors of the equity portfolio can make sense. Rather than divesting away from more overweight sectors, which were created based on portfolio strategy and allocation philosophies, diversifying within such sectors may be preferred. Investing in those companies that represent the possibility of leadership in earnings performance versus minimum volatility looks to be aligned with a positive market outlook, even given reduced enthusiasm based on current expectations for Fed action in cutting rates and market valuations. Investing over a suitable timeframe for an equity portfolio will drive such emphasis and tolerance for what could be shorter term volatility. If such volatility unfolds incidentally, selective “value” investing supplementing continued allocation to more growth-oriented alternatives can achieve diversification in not just sector participation, but also from a style standpoint. ◆

ALM STRATEGY

An Improved Operating Environment in 2025

Although it feels like the much-anticipated Fed easing cycle just started, we may actually be closer to the finish line than the starting point. At 4.50%, there will likely be some additional downward movement in the Funds rate, but probably not as much as anticipated a few months ago. However, there remains much more optimism heading into 2025 than there was a year ago, even though Fed cuts will likely disappoint versus prior expectations. A year ago, financial institutions feared the worst, and in many ways, they got it: ultra-competitive CD pricing, pressured margins, still tight liquidity, slow residential prepay speeds leading to poor mortgage loan demand, and fear of potential future loan portfolio credit problems. Fast forward one year, and although some of these items still exist, on the whole they have improved significantly.

A brief comparison vs. a year ago:

- CD pricing has improved sharply, with rates down about 150 basis points on average from the high point in the mid 5% range
- Loan/deposit growth projections indicate a return toward normal, historical levels, significantly better than assumed deposit runoff for many institutions entering 2024
- Liquidity has improved for most institutions
- Loan portfolio credit has held up better than expected, except for one off items or specific asset classes such as Indirect Auto
- Residential loan prepay speeds: OK, this one still stinks, but we can't have it all!

A Favorable Environment to Lend and Grow the Balance Sheet

So, if the business climate is better than a year ago, what does that mean, and how should that impact our approach to managing the balance sheet? Understandably, there was an aversion to adding residential fixed rate mortgages to the balance sheet a few quarters ago- rates looked good, but anticipated Fed cuts could lead to increased refinancing activity, which would shorten the lives of loans to the point where they appeared less attractive. In addition, with balance sheets still clogged with lower yielding pandemic-era loans and MBS, the relative weightings had shifted more heavily toward residential and away from commercial. To address this shift in the mix, adding commercial while allowing residential to run-off seemed like the best solution.

However, changes in expected future rates, with fewer cuts likely, means that the prepayment profile looks more favorable. Combined with now lower funding costs, the spread on this asset class looks better than it has in some time. Assuming a 6.75% rate, spreads should be greater than 250 basis points when funded with a combination of CD specials (range of 3.75%-4.25%), FHLB Option Advances (under 4%, depending on structure), short-term advances (around 4.5% but likely to decline in 2025) and excess liquidity (currently earning 4.4%).

Although the numbers look attractive, there continues to be tight inventory and lackluster demand, at best. The good news is that with fewer institutions actively lending currently (and as has been the case for the last few quarters), competition should remain lower than in 'normal'

Commercial real estate remains as competitive as ever, but also offers more demand, along with favorable pricing. Current rates for CRE are relatively similar to residential mortgages, but do exhibit a wider range, as has been the case for the past few quarters. Driven largely by competitive factors, rates seem to be in the low 6% to high 7% range, with most around 6.75% - 7.25%. Similar to residential mortgages, the spreads look favorable and argue for additional balance sheet lending, with nearly all institutions actively looking to boost commercial.

What are the Warning Signs for 2025?

Although signs point to an improving environment this year, that is by no means a guarantee, as there are a few rather large unknowns that need to be answered. One of the big ones, obviously, is the strong growth agenda of the new administration and its impact on inflation and Fed policy. Tariffs continue to be discussed as potentially having the most inflationary potential; however, it depends on how they are applied. Across the board, blanket tariffs are assumed to be inflationary, as they could drive broad-based price increases. Targeted tariffs, which are meant to start a negotiation, would likely produce very different results. Other potential policy initiatives such as tax cuts or reduced regulatory burden would also be stimulative, potentially leading to increased inflation. In this scenario, the Fed could find it difficult to continue lowering rates as prices are rising. Even before these initiatives, the CPI has been trending higher, with the Headline number increasing from a low of 2.4% a few months ago to 2.6%, 2.7%, and then most recently 2.9%. If this continues and inflation ticks above 3%, there will be market pressure to leave rates unchanged, even as the administration likely pressures for lower rates.

Under this scenario, if the Fed ended its easing campaign, funding costs would likely at least stabilize but potentially drift higher, stalling the current improving trend in margins. In a more dire scenario, stronger than anticipated economic growth pushes inflation to the point where the Fed needs to reverse course and hike in 2025. Although this is certainly not our base expectation, there are circumstances where this occurs and significantly impacts margins through another round of rising funding costs.

An additional potential concern for 2025 is the continued weak residential mortgage market, not necessarily for resi mortgages specifically, but for the impact on the CRE market. Many expect the resi market to be weak in 2025, so that would be no surprise, but an additional weak year on top of the prior weakness would force institutions to focus even closer on commercial lending. In this scenario, there could simply be too many institutions and too much money aimed at a loan type with not enough demand, which would drive pricing down. This may not seem much different than the last couple of years, however, as competition and weak resi-lending has already done this to a large degree. ◆

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The ADVISOR is a publication of EPG Incorporated

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