
2025 Outlook: Meet the New Boss. Same as the Old Boss?

By George Mateyo, Chief Investment Officer; Stephen Hoedt, Head of Equities;
and Rajeev Sharma, Head of Fixed Income



Introduction

Regardless of your political preferences, most will agree that the 2024 election was decisive: Donald Trump is returning to the White House, becoming only the second president to win a second nonconsecutive term; the first being Grover Cleveland in 1892. In addition, Congress will be under Republican control, and while the margin in the House of Representatives is very narrow (220–215)*, President-elect Trump will likely feel emboldened to push ahead on many of the promises he campaigned on.

It was not unexpected, therefore, that in the days and weeks immediately following the election, risk assets rallied with several “Trump trades” surging to new heights. The boost was partly due to the removal of uncertainty, as most found some solace knowing that the transition of power will be a smooth one. But the surge within certain segments of the financial markets was also in anticipation that those areas that performed best during Trump’s first presidential term would perform the best in his second term. Traders, it would seem, were quick to extrapolate the past onto the present.

It is therefore important to address the following questions:

- Will Trump be able to enact the changes he proposed, or will they prove to be mere campaign pledges with little likelihood of becoming law, or will roadblocks stand in his way?
- If he is successful at implementing most (or even some) of his proposed policies, what impact will they have on the economy and markets?
- If history does repeat, will investors’ recent enthusiasm prove prescient, or will they “get fooled again”? [After all, we recall many market participants being surprised by the 40% stock market rally from November 2016 to January 2018.]

No one knows the answers to these questions with certainty and handicapping how the political landscape will evolve is fraught with tremendous ambiguity. Moreover, as we’ve said before, **“Presidents don’t make economies, but economies can make presidencies,”** suggesting that larger forces play a greater role in influencing the economy, many of which are beyond the president’s control. That said, what we can say is that some aspects of Trump’s new term will be similar to his first administration, whereas others will be different, creating a highly nuanced investment environment for investors to navigate and offering a unique set of risks and opportunities in 2025.

Quick election recap: Two definitive conclusions

We will leave the detailed, retrospective analysis of the 2024 election to the pundits and political scientists, but by our lights, there are two definitive conclusions that could be made when assessing the election outcomes. First, **voters want change**. In the last three presidential elections, the outcome was a near-perfect mirror image of the prior election, a direct manifestation of voters’ fickleness:

Number of Electoral College Votes	2016 Election	2020 Election	2024 Election
Democratic candidate	232	306	226
Republican candidate	306	232	312
Total	538	538	538

Highlighted section = winning candidate

“Some aspects of Trump’s new term will be similar to his first administration, whereas others will be different, creating a highly nuanced investment environment for investors to navigate and offering a unique set of risks and opportunities in 2025.”

The same conclusion could be reached by reviewing the composition of Congress over time. For over a century, from roughly the 1880s to the mid-1990s, one political party held control over Congress for an extended period, commonly spanning more than 20 years. The Democratic Party, for instance, held a majority in Congress for four decades (1955–1995). Since then, however, the length of time one party has held control has averaged fewer than six years. And while the reasons for this compression of control are varied, one thing seems clear: **Voters want change.**

This dynamic could also be seen in an exit poll taken by NBC News shortly after the election on November 8, 2024. Here, 70% of those surveyed viewed President Trump as the “change candidate” compared with 23% of those surveyed viewing Vice President Kamala Harris as such. Given his decisive win, it can be inferred that by voting for Trump, many Americans were voting for change.

The second conclusion from the 2024 election is also straightforward and two-fold: **Voters don’t like inflation and the economy matters ... a lot.** According to The Wall Street Journal and AP VoteCast, 96% of voters said “high prices for gas, groceries and other goods” were a key factor behind their vote. This is a stunning statistic, especially when considering the annual rate of change of inflation peaked two years ago and has fallen considerably, while the job market and wage growth have generally remained strong.

But to many Americans, inflation is not measured by the annual rate of change. This is the method most economists use. To many Americans, inflation is measured by the prices they pay for something that they consume on a regular basis. And by this measure, the level of prices is painfully still too high, proving convincingly that James Carville (a political strategist advising Bill Clinton in 1992)

was right: “It’s the economy, stupid!” he would proclaim, which is to say that the economy is the dominant issue that voters care most about.

[As an important aside, along with frustrations over inflation, an increasing number of Americans (and many citizens in other countries) are frustrated by the widening wealth inequality and possess a deep mistrust of “the establishment.” This has many critical longer-term implications that we may address in 2025. But for now, this reinforces the notion that voters will continue to vote for change, further compressing the time clock for elected officials to sufficiently address voters’ concerns.]

Thus, as we contemplate the year ahead, it is important to review various aspects of Trump’s proposals and assess how they might alter the economy going forward.

Importantly, **promises are not policies**, and are by no means assured. Still, in the following section, we try our best to gauge the potential impact of the incoming president’s proposals along three dimensions: economic growth, inflation, and our country’s deficit situation. We further highlight which proposals are relatively easy to enact (but still not assured) via executive action, and which require congressional involvement and cooperation (which is also not guaranteed given the above-referenced narrow majority in the House). We also attempted to order them by when they may become enacted, an inverse correlation with Congress’ likely involvement, though this ordering may prove overly simplistic.

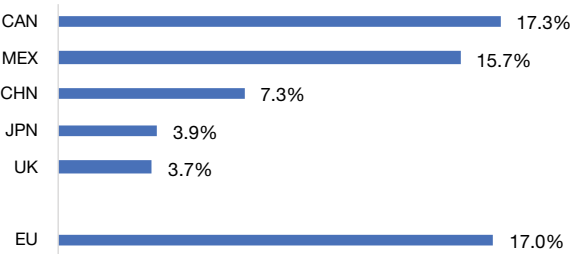
Having acknowledged these caveats (and omitting others), below is our assessment of some of the major pillars that will likely define the incoming administration’s policy agenda in 2025, along with a few nonpartisan facts surrounding each issue for context.

Tariffs

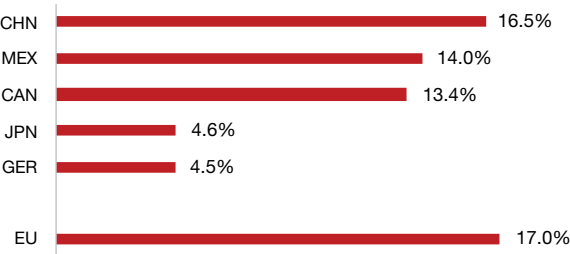
Growth Impact	Inflation Impact	Debt/Deficit Impact	Congressional Involvement
Negative	Negative	Slightly positive	Limited

- As a candidate, Trump reiterated his longstanding belief that tariffs are an effective tool. In fact, he stated rather plainly that he plans to initiate a 10% tariff on all imports, and a 60% hike on imports from China. He also has threatened tariffs as high as 100%, “and maybe higher.” We suspect that such statements may be hyperbole, but we should still take him seriously in principle.
- With the expansion of presidential power over the preceding decades, the levying of tariffs today rests largely with the executive branch, although administrative procedures could delay their implementation. Still, tariffs are likely to be instituted, which will expectedly result in an increase in inflation, and possibly be followed by a reduction in demand as consumers balk at higher prices.
- That said, various scenarios could unfold altering this calculus. For example, some countries may elect not to retaliate proportionately, or perhaps not at all, which would be positive for growth and less problematic for inflation. Too, tariffs have the potential to generate extra revenues for the government, which could improve our deficit situation, though tax cuts could offset that.
- Most of all, the impact of tariffs will be largely determined by the timing of their rollout (are they announced separately from other policies?); the targeted nature of the tariffs (are they applied to certain goods or applied more broadly?); and their intensity (how long will they be enforced?).
- In short, we believe it would be appropriate to assume that tariffs will likely cause inflation to remain stickier and growth to be curtailed all else being equal, but it’s not a clear-cut case, and various scenarios could unfold, making the range of outcomes extremely wide.

Top 5 largest purchasers (plus EU)
of U.S. exports (\$2.1 trillion)



Top 5 largest suppliers (plus EU)
of U.S. imports (\$3.2 trillion)



Sources: Office the United States Trade Representative (www.ustr.gov); Key Wealth Institute.

Immigration

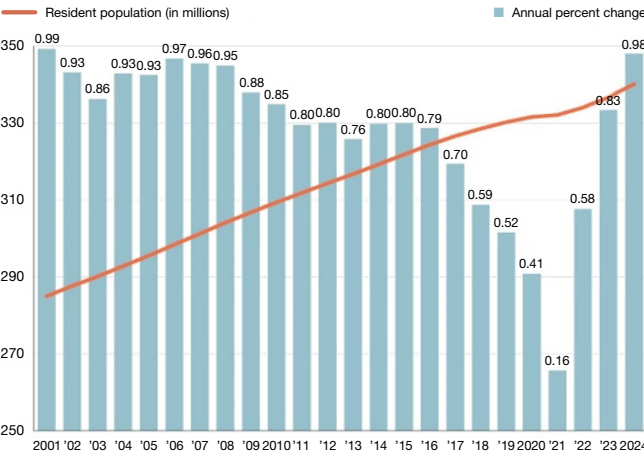
Growth Impact	Inflation Impact	Debt/Deficit Impact	Congressional Involvement
Slightly negative	Negative	Unclear	Some

- According to the Pew Research Center, the immigrant share of the U.S. population peaked in 1890 at 14.8%. It then steadily fell, before bottoming at 4.7% in 1970, which coincides with changes Congress made to U.S. immigration laws in the mid- to late-1960s.
- Fast-forwarding to today, immigrants account for 14.3% of the U.S. population (back near an all-time high), or a record 47.8 million people, up 1.6 million from the prior year. Of this population, more than three-quarters were either fully naturalized U.S. citizens, lawful permanent residents, or lawful temporary residents, leaving approximately 11 million people as unauthorized immigrants, or 3.3% of the

total U.S. population. Moreover, in 2024, the rate of immigrants grew at its fastest over a generation, outpacing the growth of the U.S. population by a material margin (see charts below).

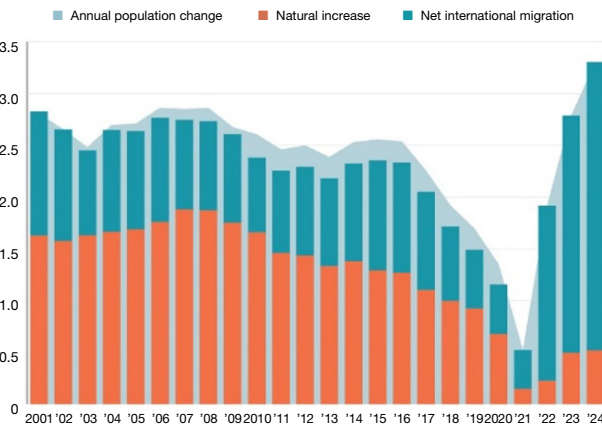
- Along with tariffs, another refrain regularly asserted during Trump’s campaign was the need to “seal the border,” restrict immigration and initiate mass deportations shortly after assuming office. Specifics are lacking and logistics may prove challenging, however, and, unlike tariffs, other parts of the federal government will likely be involved in this area.
- While data is imprecise, the growth of the immigrant population was likely a positive for economic growth and a contributor to lower inflation, especially wages. Therefore, should Trump’s campaign rhetoric over mass deportations become reality, wage inflation will likely remain stickier, and growth will be slightly weaker. But once again, it’s not a clear-cut case, and various scenarios could unfold.

Annual percent change in population:
July 1, 2000 – July 1, 2024



Note: In some cases, the labels for percent change may be identical, yet the bar heights might differ slightly. The difference is due to rounding.
Source: U.S. Census Bureau, Vintage 2024 Population Estimates, 2000–2010 and 2010–2020 Intercensal Estimates.

U.S. annual population change, natural increase, and
net international migration: July 1, 2000 – July 1, 2024

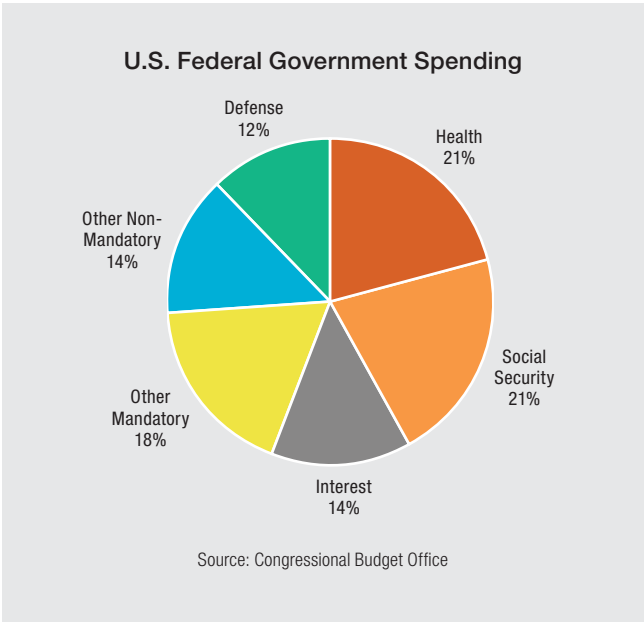


Note: For the years 2000 to 2020, the sum of natural increase and net international migration may differ slightly from the annual population change. This is because population change is derived from the intercensal estimates, which do not include the components of population change. The components of change are based on postcensal estimates. For more information on the difference between intercensal and postcensal estimates, please visit census.gov/programs-surveys/popest/guidance.html.
Source: U.S. Census Bureau, Vintage 2024, 2020, 2010, and 2000 Population Estimates; 2010–2020 and 2000–2010 Intercensal Estimates.

Deregulation

Growth Impact	Inflation Impact	Debt/Deficit Impact	Congressional Involvement
Positive	Positive	Unclear	Moderate

- In fiscal year 2023, the federal government spent roughly \$6.2 trillion, implying that federal spending equated to nearly 25% of the total economic activity of the U.S. that year, or nearly \$18,500 per person. The federal government spent 38% more than it collected in revenues that year, resulting in a \$1.7 trillion deficit. (We will address the deficit in greater detail in a subsequent section.)
- Government spending is allocated as follows: 74% is spent on mandatory spending programs such as Social Security, Medicare and Medicaid, and interest payments on existing debt outstanding (which alone totals 14%). These are thought to be nonnegotiable. Of the remaining items the government spends money on, 12% is directed toward national defense, leaving 14% (roughly \$1 trillion) spent on discretionary, non-defense items.



- We present these statistics to put into context what the president-elect and his team have proposed regarding deregulation. More specifically, talk of \$2 trillion of spending cuts would represent nearly one-third of total federal government spending, a staggering sum which may be difficult to achieve given that, as noted above, only \$1 trillion is spent on non-mandatory items, excluding defense.
- Too, it is conceivable that every line item in the federal budget has at least one member of Congress believing that said expense is critical to her/his constituency, thereby rendering its elimination as difficult to achieve. Finally, such an immense reduction in spending, while positive for the U.S. budget deficit, would likely create a headwind for economic growth. Notably, however, details are lacking.
- Still, we view deregulation as a positive and acknowledge that inefficiencies within the federal government are abundant. As one report noted: “Frozen cheese pizza is overseen by the FDA, but a pepperoni pizza is regulated by USDA. Chickens are regulated by the USDA; the eggs they lay are regulated by the FDA; and if the eggs become an omelet, that is regulated again by the USDA. ...”
- That said, as with other aspects of Trump 2.0, deregulation will not be a clear-cut case: some sectors will be beneficiaries: The outlook for energy and financial services companies is generally considered to be positive. Conversely, certain healthcare companies may face a more challenging regulatory environment, while the outlook for technology companies is mixed (some will benefit, whereas others will face scrutiny).
- In sum, deregulation will likely be a positive for the economy in 2025, and mergers and acquisition activity, which is typically pro-growth, is anticipated to increase as a result. This should be especially favorable for smaller firms. But as noted above, a significant reduction in federal spending could stymie growth, though once again, various scenarios could unfold.

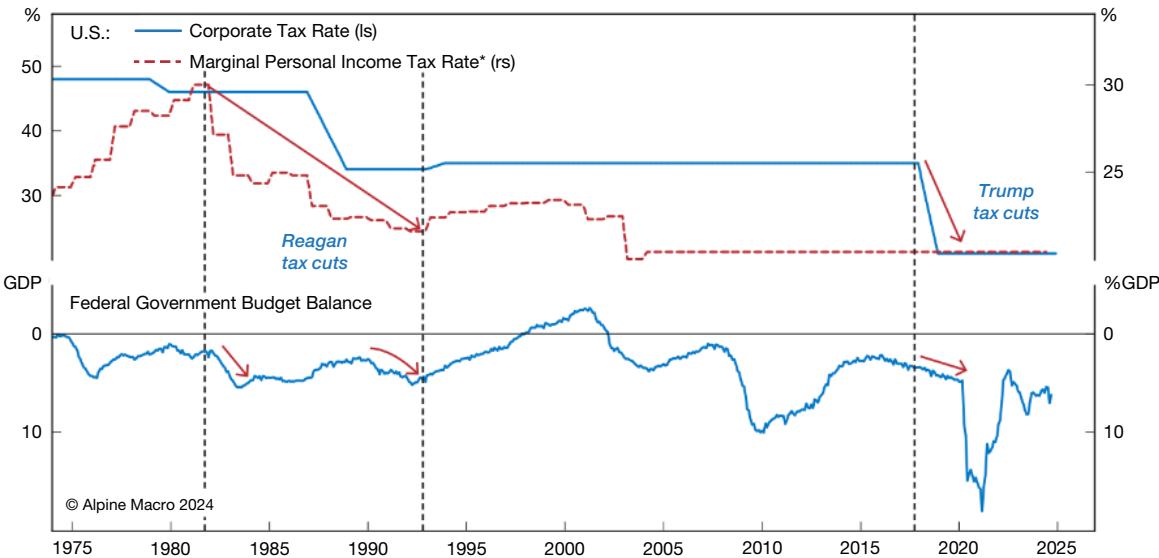
Tax Policy

Growth Impact	Inflation Impact	Debt/Deficit Impact	Congressional Involvement
Slightly positive	Neutral	Slightly negative	Considerable

- Of all the potential policy changes that may come about in 2025, tax-related policies will command considerable attention as several elements of the signature legislation from Trump 1.0 are scheduled to sunset in late 2025. It is also the area where the Republican-controlled Congress will likely prove most beneficial and is likely responsible for the biggest boost in equity prices post-election, for had the outcome of the election differed, tax policy also would have differed.
- More specifically, key provisions within the Tax Cuts and Jobs Act (TCJA) of 2017 will expire in 2025, and while the corporate tax rate of 21% is not one of the expiring provisions, it most likely would have been raised under a Democratic administration (both Biden and Harris supported this).
- Now, however, tax hikes are seemingly off the table. In fact, there is speculation that additional tax cuts are being considered, including mention of the corporate rate being lowered to 15%, which would make it one of the lowest tax rates in the developed world.

- Given the fiscal backdrop, however, we view the likelihood of domestic U.S. tax rates moving substantially lower as low, but certain “sweeteners” could be added that would help justify the recent stock market advance, as they would likely boost the outlook for corporate earnings. Trump has also floated other tax proposals including exempting tips, Social Security benefits, and overtime pay from taxes, as well as deductions for car loan interest and state and local taxes.
- It is unclear, however, whether there would be any corresponding offsets, as these tax cuts would likely expand the federal deficit, which will likely rise considerably even without them assuming the individual tax cuts within TCJA are extended in 2025.
- Thus, we view tax policy as having a favorable impact on the economy but having a slightly negative impact on our country’s fiscal situation as major tax cuts almost certainly create bigger deficits. Positively, however, lower tax cuts and fiscal stimulus typically boost near-term economic growth.
- Still, barring an upside surprise in economic growth, and provided that interest rates don’t rise materially higher, we believe a major change in the tax code is unlikely. Yet, the idea that taxes are not projected to move higher is positive.

U.S. tax rates and federal deficit



* For taxpayers with household incomes at twice the median.

Summary

Since entering the race, and while some details have varied (or in some cases been nonexistent), Trump’s economic policy has been consistent and clear and is composed of the following components: Levy tariffs and impose stricter immigration policies to protect domestic jobs, and use revenues generated by tariffs to lower (or at least maintain) domestic tax rates and loosen regulations to bolster economic growth. That said, the path to enacting such policies, in our view, is not as clear, potentially causing some volatility in the financial markets if traders’ current optimism over future economic growth is delayed or outright denied. Furthermore, as we tried to suggest above, the range of potential outcomes is exceptionally wide.

Tariffs, for instance, may be subjected to administrative delays, and prospectively assessing how other countries (and companies) respond necessitates a vigorous amount of game theory, resulting in a large number of unknowable outcomes. Similarly, tighter immigration rules may prove difficult to institute (or enforce), and there is ambiguity as to how they might alter the U.S. labor market.

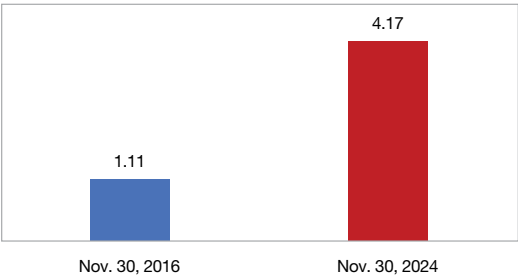
Lower regulations generally make good sense, but they may be subjected to a protracted political process, and not all sectors will be treated equally. Finally, under Trump 2.0, taxes are unlikely to move higher; however, they are unlikely to move materially lower given our country’s current fiscal situation.

What’s more, if we look back eight years ago and compare the state of our economy today with that of 2016, we see a strikingly different landscape: Interest rates and inflation are markedly higher, and our nation’s deficit is twice as large relative to the size of GDP and is \$1 trillion larger in dollar terms. These dynamics may create a challenging setup for the incoming administration to push their policies through with ease.

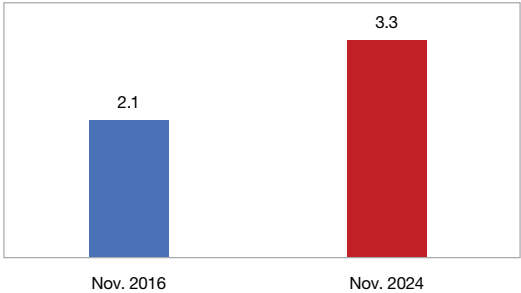
“Meet the new boss. Same as the old boss? Not so fast.”

Given this, combined with extended valuations on risky assets, investors’ expectations could be rendered as overly optimistic, sparking some volatility. And thus, while many are concluding that the new boss will be the same as the old boss (and on some fronts that may be true), we advise against indiscriminately extrapolating the past onto the future and believe some caution in the near-term may be warranted.

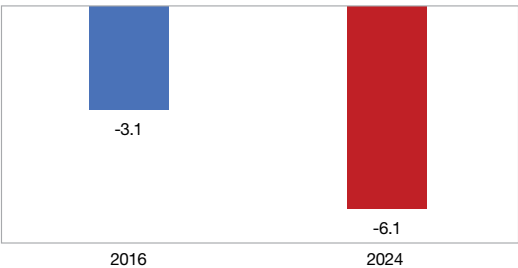
2-year U.S. Treasury Yield (%)



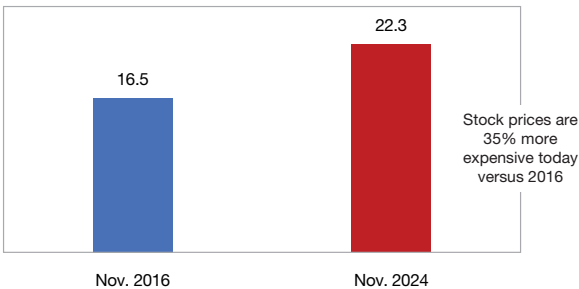
Core Inflation (yr./yr. %-chg.)



Federal Deficit as a % of GDP (%)



S&P 500 Index P/E Ratio (x)



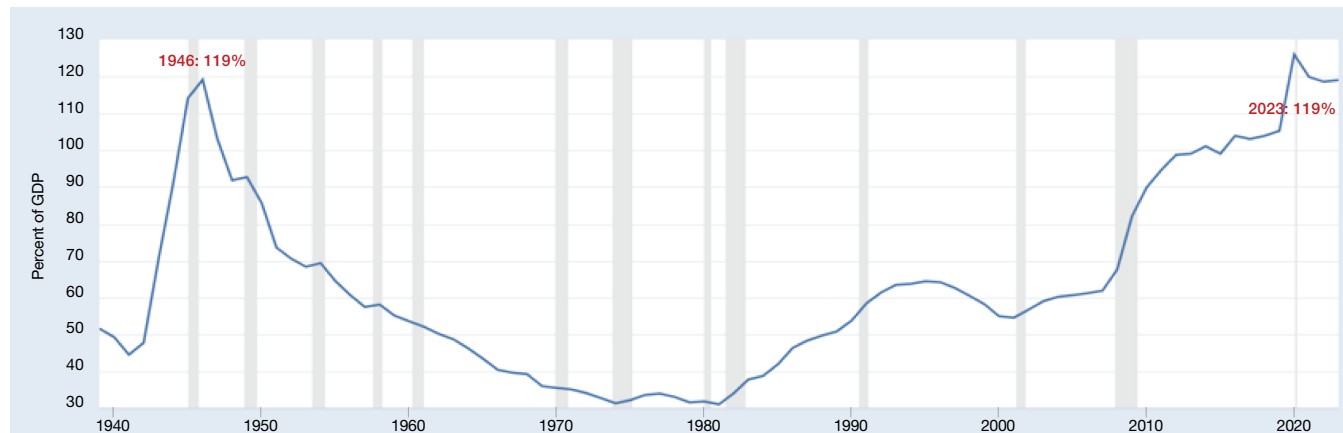
Sources: Federal Reserve Bank of St. Louis; Bloomberg; Key Wealth Institute.

Special topic: Is America exceptional, and how do we know if we are approaching a federal debt crisis?

As noted earlier, many believe our country faces significant risks due to our nation's deficit. Such concerns are justified, as the total U.S. federal debt has risen to historic levels and now exceeds the total amount of annual output generated by the economy (i.e., GDP).

It is interesting to introduce a term, therefore, that many use to describe the breathtaking out-performance the U.S. economy (and our stock market) has experienced relative to the rest of the world: **American Exceptionalism**.

Gross Federal Debt as Percent of Gross Domestic Product



Source: Federal Reserve Bank of St. Louis (shaded areas indicate recessions).

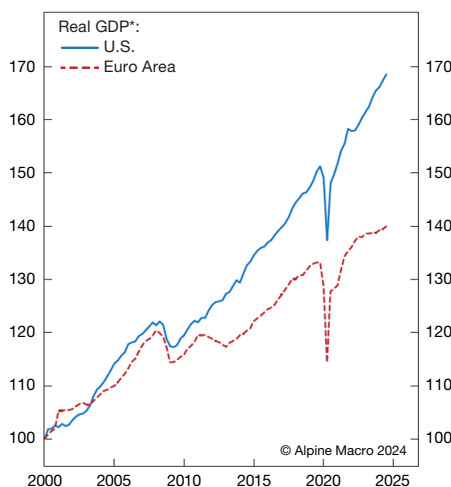
According to Encyclopedia Britannica, American Exceptionalism is “the idea that the United States is a unique and even morally superior country for historical, ideological, or religious reasons,” and is attributed to French political scientist Alexis de Tocqueville, who described America as “exceptional” following his travels here in 1831.

Much more recently, some economists and market strategists have used the term to exemplify the observation that in the last 10 years, U.S. stocks have more than tripled, rising an astounding 239%, or 13% per annum, (noticeably above long-term average returns), whereas

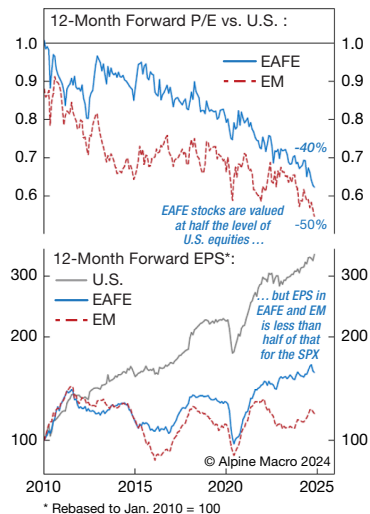
stocks in developed international markets have gained less than one-third as much (74%), and stocks in emerging markets (which are usually synonymous with faster growth) have

advanced 49%, barely exceeding inflation. As a result, U.S. stocks trade at roughly a 50% premium relative to stocks in the rest of the world, the largest premium ever.

US Economic Growth and Equity Valuations Relative to Other Regions of the World.



Source: Alpine Macro



In his Equity Market Outlook, Steve Hoedt explains the drivers of these returns and offers his assessment as to whether they will continue. But what might sound ironic is the fact that countries that have pursued fiscal austerity have experienced economic pain, suppressed corporate profits, and subpar investment returns, begging the question: How does one balance American Exceptionalism against a massive federal deficit and worrisome levels of debt?

In the simplest of terms, the U.S. can maintain such high debt levels because investors believe they will be repaid. They also recognize that our economy is blessed with unique assets, both economically and geographically, but also culturally in the form of an unrivaled spirit of innovation. Additionally, our financial markets are the deepest and most liquid in the world, and the rule of law exists to protect both entrepreneurs and shareholders.

Said another way, the U.S. can maintain such high debt levels because it can, and while it is unlikely that politicians will act preemptively, and we must be mindful not to minimize this incredible privilege, elevated debt levels won't become a problem until the markets say that they are a problem. When such a day will come is unknowable, but the following are some things that could presage a debt crisis:

- Government exhausts its ability to raise taxes
- Traditional sources of debt financing dry up, requiring alternative funding strategies
- The average interest rate on government debt persistently exceeds nominal GDP growth
- Interest payments account for an increasingly larger share of government revenues, crowding out discretionary spending and requiring tough budget actions to stop the deficit from rising
- Fears of inflation and/or default leading to a rise in interest rates and a falling exchange rate
- An angry and organized electorate forms to criticize the government for eroding living standards, high taxes, and pressure continues to cut spending

None of the above conditions is present today.

And while the proposition that elevated debt levels won't become a problem until the markets say otherwise may leave some feeling uneasy, it underscores the importance of diversification, being attentive to risks, remaining disciplined (especially at the height of uncertainty), and being open to a range of outcomes that may unfold, including things unforeseen or unimagined ahead of time.

Investors recognize that our economy is blessed with unique assets, both economically and geographically, but also culturally in the form of an unrivaled spirit of innovation. Additionally, our financial markets are the deepest and most liquid in the world, and the rule of law exists to protect both entrepreneurs and shareholders.

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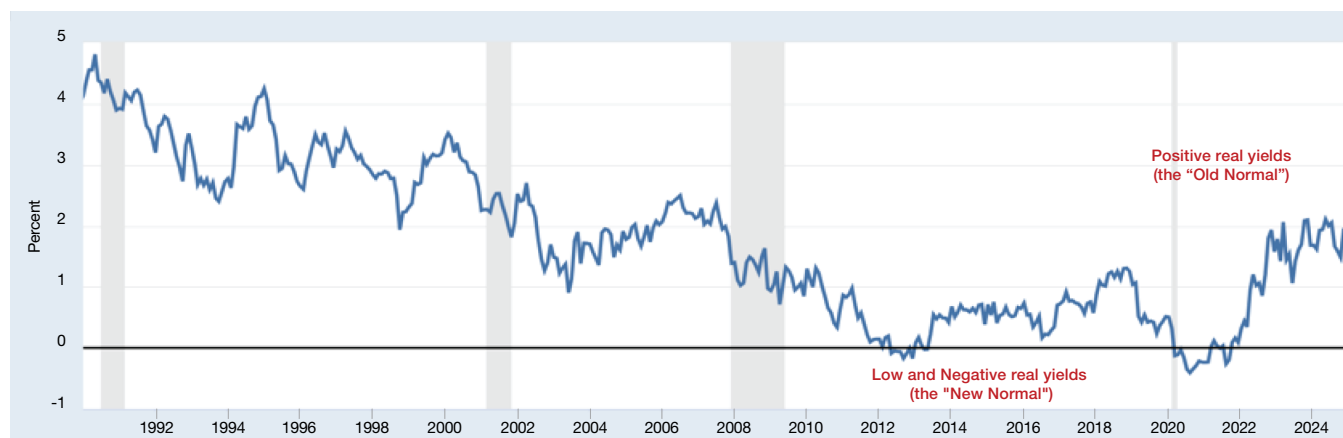
Economic and investment Outlook: Moving further down the road of the Old Normal

In our **2024 Outlook**, we stated that the economy was transitioning from the “New Normal” to the “Old Normal.” In our parlance, the “New Normal” was a reference to the period following the Great Financial Crisis (“GFC”) in 2008 that was extended following the COVID-19 pandemic into 2021. During this time, the cost of money, or real interest rates (interest rates adjusted for inflation), was extremely low and financing was easy to secure, even for borrowers with subpar credit scores and businesses that were profitless.

This had several effects on the economy, many of which are still being felt. Most notably, of course, is the rampant rise in inflation.

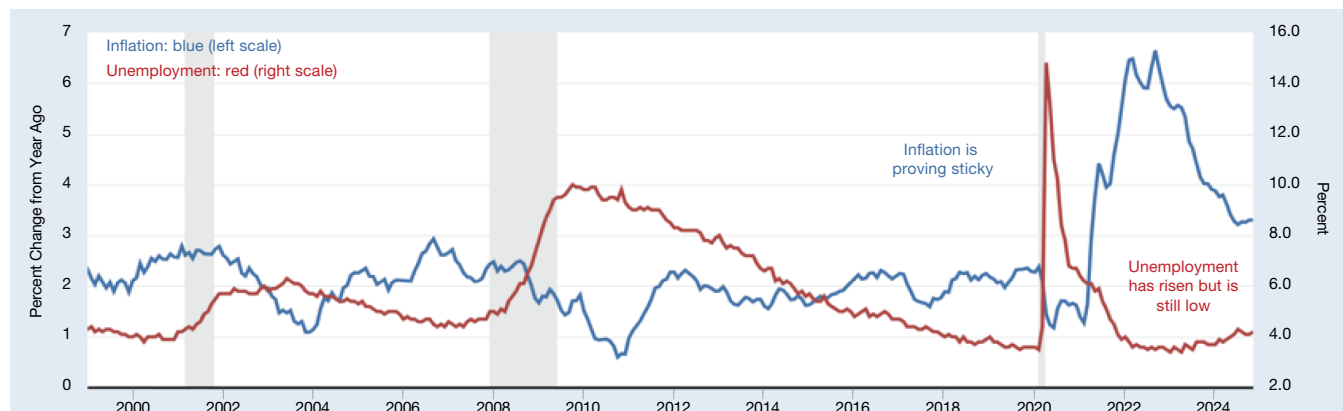
A year ago, we argued that inflation would continue to moderate, but it would fail to fall to or below the Fed’s 2% target, and thus while we believed that the Fed would begin lowering interest rates, we foresaw far fewer rate cuts than the markets were anticipating. “The economy may be firmly on the road back to the Old Normal, with inflation likely to hover between 2% and 4%, versus the 0%–2% range it occupied during the New Normal, we stated.

10-Year Real Interest Rate



Source: Federal Reserve Bank of St. Louis (shaded areas indicate recessions).

- Consumer Price Index for All Urban Consumers: All Items less food and energy in U.S. city average (left)
- Unemployment rate (right)



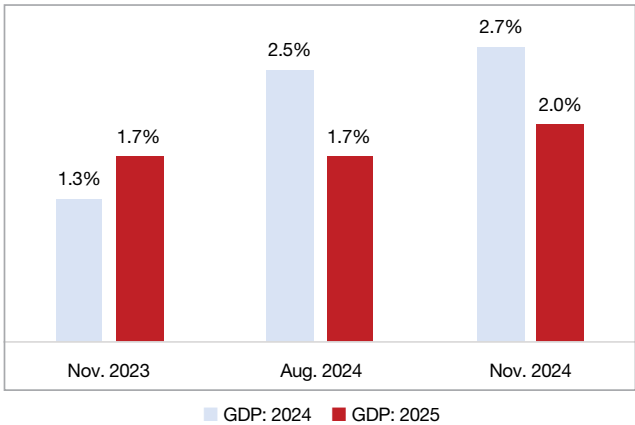
Source: Federal Reserve Bank of St. Louis (shaded areas indicate recessions).

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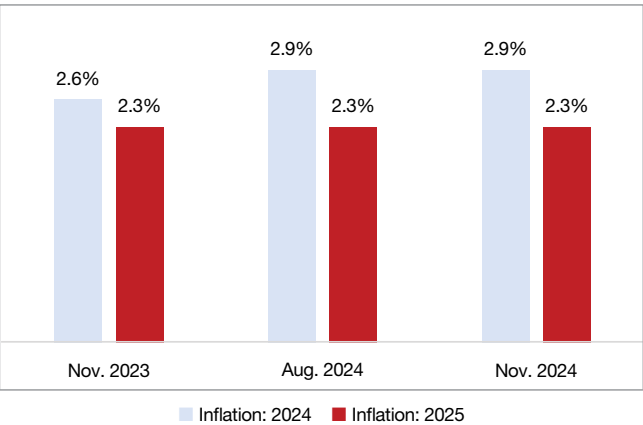
A year ago, we also cautioned that the Fed, in its efforts to bring inflation closer to target, could cause unemployment to rise, although we stopped short of calling for a recession, asserting “... we remain optimistic that the economy can continue to expand so long as wage growth persists, and the job market continues to grow.”

This was not a preordained outcome. In fact, it would mark one of the few times in the past seven decades when the Fed raised interest rates to stem inflation without triggering a recession. Yet, we argued that both the corporate and consumer sectors were in relatively decent shape, thus creating the conditions for a much-hyped “soft landing” to occur. The consensus, meanwhile, was far more negative, with economic forecasts that were barely positive. This can be seen in forecasts made a year ago as illustrated in the chart below (see Nov. 2023).

GDP Forecasts



Inflation Forecasts



Source: Bloomberg; Key Wealth Institute

Since then, growth expectations have risen materially and also, notably, since the election for reasons we enumerated earlier (expectations that taxes will remain low, deregulation will give rise to animal spirits, etc.). Over the course of the full year, though, faster than expected economic growth has risen because of stronger than expected consumer spending (particularly on “experiences” versus “things”), better than expected business spending (namely AI-related, or artificial intelligence), and faster than expected government spending (which has resulted in a larger-than-expected deficit).

Importantly, each of these levers will need to be sustained for above-trend growth to continue, and while we remain in the “no recession” camp, we have some concerns, too. To wit, while consumer spending in the aggregate should persist, lower-income consumers and younger wage-earners are increasingly feeling strained. Similarly, government spending, as noted earlier, is poised to

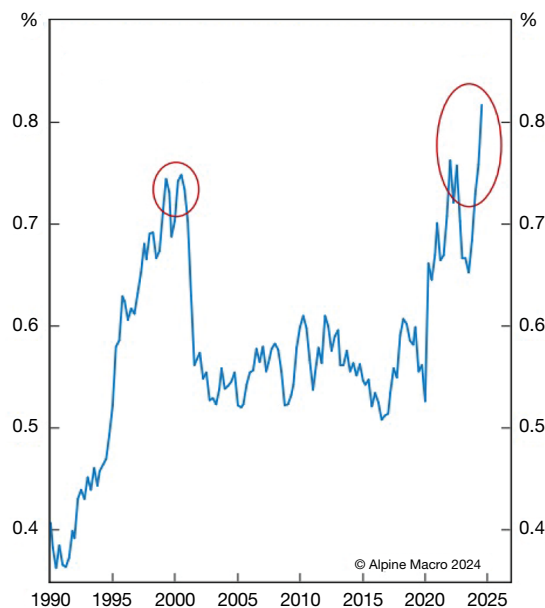
come under considerable scrutiny by the incoming administration, which could result in a tightening of the purse strings. Last, and perhaps the biggest risk of all, many companies involved in the enabling of AI have spent massive sums in anticipation of large demand. Yet, the early tally from companies thought to be leading the adoption of AI has been mixed, which could result in a slowdown in future spending.

More specifically, the promise of artificial intelligence is difficult to overstate, with its loudest proponents suggesting that it will facilitate some truly astonishing things. Among them: the eradication of many (some think most) diseases, a solution for climate change, the end of poverty, and a complete rethink of how work is done throughout nearly every sector of the economy, which, as a result, will propel an unprecedented boom in productivity.

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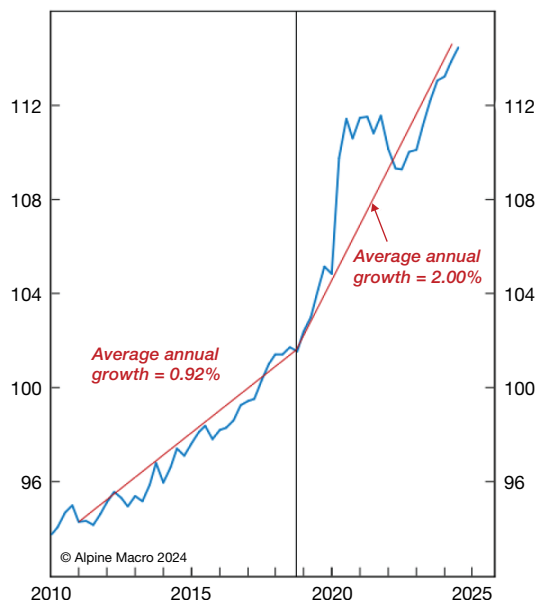
Sensing this excitement, construction of datacenters used to warehouse the necessary computing power has risen seven-fold in the past two years; utility companies are witnessing unparalleled demand for electricity to power these datacenters; and companies developing AI technologies are allocating tens of billions of dollars on capital expenditures, most of which are directed at artificial intelligence.

U.S. Private Fixed Investment in Computers and Peripheral Equipment as % of Real GDP



Source: Alpine Macro

U.S. Labor Productivity



Against this excitement, it is imperative to be mindful of prior cycles defined by massive capital spending in pursuit of “the new, new thing,” as such a dynamic typically results in excess capacity and ultimately leads to investor disappointment on a large scale. Those who were investing in the late 1990s/early 2000s know this story all too well. For those who weren’t, for now, we would simply say that the infrastructure that was initially built during the commercialization phase of the internet was so massive that the excess inventory is just now being worked off ... 20-plus years later. In short, investors will likely become more discriminating that the spending is profitable spending, meaning that investors’ capital is being spent wisely and it generates a return commensurate with the level of risk being taken.

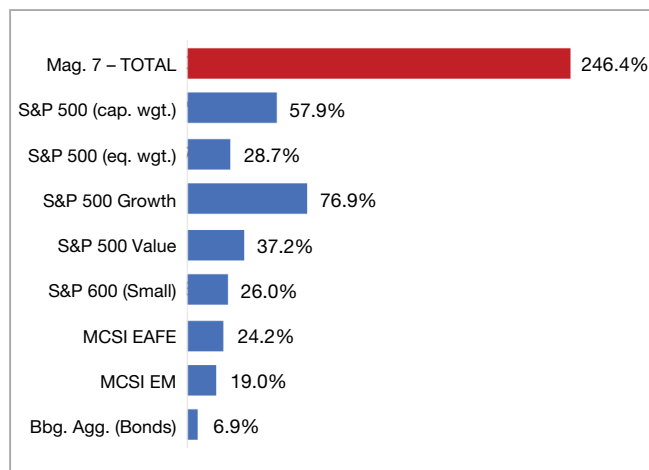
This discussion, in our view, will become increasingly important given the fact that AI enablers, also known as “hyperscalers,” have become a dominant part of many widely used stock market indexes, to which many investors are widely connected via index funds and other passive investment options.

As of November 30, these companies, also referred to as the “Magnificent 7,” represented nearly one-third of the S&P 500 Index. Such index concentration is at historic levels.

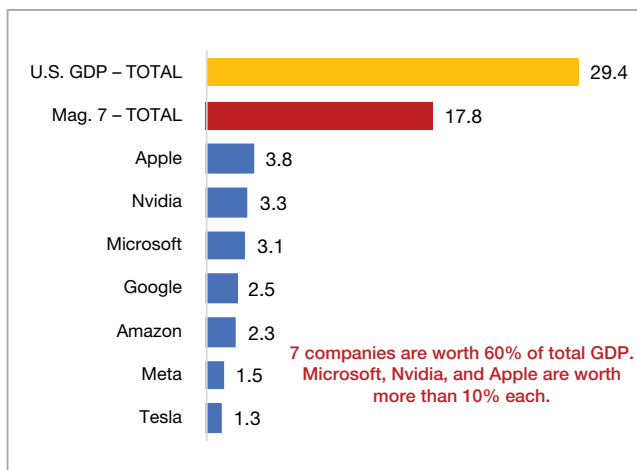
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Moreover, the market value assigned to these companies also reached a fevered pitch as shown in the charts below. Here, on the chart on the right, we highlight the fact that the Magnificent 7 (arguably seven of the most popular stocks today) have an aggregated market value that approximates 60% of the entire U.S. economy (as measured by GDP).

Total Cumulative Returns (Jan. 21, 2023 – Dec. 31, 2024)



Magnificent 7 Market Cap vs. Total U.S. GDP (\$-trillions)



Source: Bloomberg; Key Wealth Institute

Such concentration, while at extreme values, does not suggest these companies will soon face decline. They could very well extend their dominance even further. However, we should accentuate the point that the values being assigned to these companies is the result of past performance (left chart); it says little about future returns. That said, judging by history, highly priced assets usually result in lower prospective investment returns.

Crucially, valuations for most asset classes enter 2025 trading at extended levels, a reflection of the optimism we noted at the beginning of this Outlook over the incoming second Trump administration and optimism that the upward reassessment of the broader U.S. economic outlook (that we also referenced) will continue. This is depicted in the following table.

Current market valuation versus history (100% = most expensive; 0% = least expensive)

Equity Indexes		
	Forward P/E	Trailing P/E
S&P 500 Cap. Weight	93%	89%
S&P 500 Equal Weight	80%	67%
S&P 500 Growth	97%	96%
S&P 500 Value	97%	83%
S&P 400 (Mid-Cap)	66%	42%
S&P 600 (Small-Cap)	72%	53%
MSCI EAFE	39%	14%
MSCI EM	68%	51%
MSCI China	36%	30%

Bond Indexes		
	Spread	Yield
MBS	63%	45%
IG Corp	100%	50%
HY Corp	93%	69%
Hy Corp – CCC	85%	73%
EM Debt	92%	54%

Source: Bloomberg; Key Wealth Institute

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Here, too, lofty valuations, by themselves, do not cause asset classes to decline, but they leave little room for error. Thus, as we mark the beginning of the new year, we approach it with excitement over the potential for new opportunities and continued growth, but also with caution given extended valuations and much optimism surrounding new opportunities and continued growth.

Investors, therefore, should remain “balanced to risk,” meaning that their portfolio allocations should roughly match their strategic asset allocation targets. We continue to advocate for the inclusion of “New Tools” to enhance the diversification of one’s portfolio, and we recommend contemplating a wider range of outcomes in 2025 and ensuring one’s portfolio will be able to withstand these wider possibilities.

We stand at the ready to assist and not just help navigate these times of uncertainty, but help understand them, prepare for them, and potentially benefit from them. We greatly appreciate the confidence you have placed in us to help serve this important mission, and we wish you good health and good fortune in the year ahead.

¹ <https://www.pewresearch.org/short-reads/2024/09/27/key-findings-about-us-immigrants/#:~:text=How%20many%20people%20in%20the,than%2020%20years%2C%20since%202000.>

² <https://thehill.com/opinion/white-house/4999762-elon-musk-doge-government-efficiency-reform/>

2025 U.S. Equity Outlook

Will the U.S. stock market remain magnificent?

With the S&P 500 Index on track for an annual return of over +20% for the second year in a row, this is a fair question. While strong back-to-back gains may seem out of the ordinary, given that the long-term return for the market is roughly 10% per annum, in truth such returns are more the norm than the exception. In fact, absent a recession, which tends to result in bear market years with negative returns, bull markets tend to span multiple years in a row with returns in the high teens or more. So, the key questions going forward are: How much “good news” has already been baked into the magnificent returns of 2023 and 2024, and does a recession lay on the horizon in 2025? Looking at the current macro fundamentals can provide us with clues.

Historically, in the 12 months following the Fed rate cut of its policy controlling interest rate, returns have averaged 11.7%. That is slightly better than the average 12-month period. When looking for a proxy for economic activity, many investors default to the ISM Manufacturing Index — an important indicator that reflects the state of the U.S. economy — due to its correlation with market returns. This index, formerly known as the Purchasing Managers Index (PMI), is a monthly indicator of U.S. economic activity. It is based on a survey of purchasing managers at manufacturing firms nationwide. When the ISM gains less than 5 points over the past trailing 12 months, as is the case today, the market has historically returned a mere 3.5%–4.5% returns, well below the +20% return achieved in 2024.

Of course, we like to look at many more indicators, but we highlight these two to illustrate the fact that returns earned in 2023 and 2024 are above their historic norms, presenting investors with a conundrum as we head into 2025. Furthermore, many crosscurrents remain in today’s macroeconomic backdrop. We do not see a simple “up-and-to-the-right” market in 2025. Our call is much more nuanced.

The market has rallied materially over the past few months, due largely in our view to the market pricing in the idea that the incoming Trump administration (“Trump 2.0”) will likely pursue more market-friendly policies than the outgoing Biden administration. The market is extrapolating from Trump 1.0 and sees significant deregulation and favorable tax policy coming down the pike. It is also taking talk of potential fiscal restraint (such as possible actions initiated by the newly created Department of Government Efficiency, or “DOGE”) with a large grain of salt.

We think the market is underappreciating the potential for near-term headwinds from the DOGE (typically reduction in government spending is a drag on GDP) and tariffs (which could boost inflation by 0.5%). Currently, the consensus sees S&P 500 earnings growth for 2025 of 15%, which is above historic norms, all while the market trades at 22x earnings, also historically high.

We believe that a looser Fed will likely offset some of the drag from tariffs and any attempts of fiscal rectitude, but it seems clear to us that 2025 earnings estimates need to reset lower to more realistic levels.

We have long said “earnings higher = stocks higher” and think this relationship will hold in both directions in 2025. With earnings set to fall in the first half of 2025, we see stocks having trouble making much, if any, headway from current levels until mid-year. However, with no recession on the horizon, we expect any downside in earnings to be mild. Once numbers have come down, the stage will then be set for a solid second half. In this down-and-then-up scenario, we see the S&P 500 exiting 2025 at 6,600.

Will the market leadership continue to broaden out?

Technology stocks have been indispensable to market performance, generating nearly half of U.S. equity market returns over the past five years. While it may be difficult to believe, the group's superior growth fundamentals have largely justified this outsized return contribution. Recently, the difference in earnings growth of technology companies versus the earnings growth of all other companies peaked over 40%; however, recent estimate changes suggest this differential is expected to narrow to mid-single digits by the end of 2025.

So, while the earnings of tech companies will still be growing close to double the market, the rate-of-change downshifting is what will matter to investors. We believe this argues for selectivity within the sector and suggests there are likely areas of opportunity in the more cyclically sensitive areas of the broad market.

More specifically, we believe that semiconductor stocks currently sport demanding valuations in an area of the market that has historically been notoriously cyclical. Please forgive the battle scars of a technology analyst from the 1990s and 2000s! But the capital expenditure growth of the "hyper-scalers" (companies at the forefront of the generative AI revolution) is slowing and there could be a danger of overinvestment at some point, reminiscent of the overinvestment in telecommunications equipment 25 years ago. What really draws our attention is that for all of the talk about generative AI being revolutionary, we are now more than 18 months into this being a theme the market is aware of and nobody knows yet what the "killer app" is going to be. To us, that begs for some caution.

The case for cyclicals is much more straightforward. With the Fed embarking on a rate-cutting cycle and deregulation on tap, no sector is set to benefit more from the macro backdrop than Financials. While the group has raced higher over the past few months, we think the tailwinds will persist throughout 2025. Additional upside could come in the form of merger and acquisition activity. We also see Energy as a beneficiary. "Drill baby, drill" did not work out so well for the oil patch during Trump 1.0; however, we believe that energy executives will maintain their newly found discipline. In our view, the group is positioned to be an out of consensus winner. We further believe Industrials and Materials stocks could be set to shine. In a world where tariffs and strategically secure supply chains become ever more important, we think there will be clear winners among domestic manufacturers and producers across the board.

On the flipside, we also see a couple of sectors facing significant challenges: Health Care and Consumer Staples. These groups that are traditionally viewed as defensive (i.e., recession resilient), so given our bias toward cyclicals in 2025, we see these areas underperforming. Moreover, there is material headline risk for each group due to potential changes from the campaign to "make America healthy again," which could represent both real and perceived drags to the underlying fundamentals for many of these businesses. Nobody knows, and when nobody knows, it means uncertainty goes up. Investors hate uncertainty, suggesting to us better opportunities elsewhere.

While the earnings of tech companies will still be growing close to double the market, the rate-of-change downshifting is what will matter to investors. We believe this argues for selectivity within the sector and suggests there are likely areas of opportunity in the more cyclically sensitive areas of the broad market.

What's behind the massive outperformance of U.S. stocks, and will these forces continue?

We believe that the reasons for the historical outperformance of U.S. stocks is clear. Probably the most important factor comes down to index construction. The S&P 500 Index is overweight growth stocks and underweight cyclicals, when compared to global benchmarks. In fact, the U.S. has more than three times the exposure to technology alone. This has resulted in a significant structural tailwind for domestically focused investors for well over a decade. U.S. stocks, and growth stocks more specifically, tend to re-rate higher in a slowing global GDP growth environment, which is exactly what has been occurring. The unrelenting growth of the size of technology stocks in the S&P 500 has also resulted in a large upward shift in U.S. profit margins relative to global stocks. While it is hard to see yet another large leg higher from here for profit margins, it is also difficult to see global peers closing the gap anytime soon, which suggests the ultimate fundamental tailwind behind these shareholder returns should persist.

We also believe that the U.S. possesses several structural economic advantages that have propelled U.S. stocks in the past and should continue to drive outperformance going forward. There are three enduring reasons, and one reason that can change every four years.

1. The U.S. has the most flexible labor market of any major geographic region.
2. We have fewer labor regulations, which makes it easier to reduce labor costs in response to slowing growth and sets the stage for quicker recovery. U.S. wages have also historically tended to respond more quickly to slower growth than elsewhere.
3. Finally, the Fed — due to its unique-among-central-banks dual mandate — has tended to pursue an expansionary monetary policy earlier than elsewhere.

The once-every-four-year wildcard are policy-driven tailwinds (or headwinds) as a result of the change in presidential administrations. Currently, we see corporate tax rates potentially coming down relative to other countries. We also believe material deregulation is likely — which does have an economic benefit but has an even bigger equity market impact (financials, energy, and real estate in particular). Increased merger and acquisition activity is also probable in such an environment, especially if large-scale M&A is allowed to create bigger “national champions.” Finally, we see the new administration pursuing an industrial and trade policy designed to help U.S. manufacturing relative to global peers and encourage reshoring.

What are the risks, and what are the opportunities?

If there is one thing that keeps us up at night, it would be an unexpected resurgence of inflation. Inflation on a global basis has come down notably over the past couple of years, but it remains above most central banks' targets. Core inflation remains further above targets in countries where the surge in inflation during the pandemic was the largest.

With this backdrop, it is notable that the Federal Reserve is embarking on an easing cycle. Are they repeating the mistakes made by the Burns Fed in the 1970s, which saw a second wave of inflation follow a premature easing cycle in the middle of the decade? Only time will tell. What is clear to us is that headline inflation is likely to move up in the next few months as energy prices contribute less to disinflation on a year-over-year basis, while risks from potential increases in tariffs and immigration policy loom as a potential accelerant from mid-2025 and beyond.

We think investors will be well-served to have some stocks in their portfolios that benefit from a scenario where inflation comes back, along with exposure to quality growth, akin to a barbell in the fixed income markets.

When thinking about equity market risks, one need look no further than credit markets, which have served as a reliable canary in the coalmine since the advent of high-yield bonds in the 1980's. So goes high-yield bonds, so goes stocks, another adage we have regularly repeated. With investment-grade and high-yield credit spreads at or near their tightest levels in 25 years, how much better can it possibly get?

Judging by flows, the appetite of investors focused on duration matching (pension funds) remains unabated even at current levels. The strong economy has resulted in very low defaults, further justifying tight spreads. Absent some kind of a "credit event" (a la Lehman Brothers) and with recession probabilities low due to an easing Fed, it is difficult to see credit becoming a material issue for stocks in 2025. This suggests that stocks will likely move past the 1H 2025 earnings weakness, and any pullback or correction should likely be bought.

Finally, maybe the biggest risk of all, but also the most difficult to quantify, is geopolitical risk. We firmly believe that the era of 'Pax Americana' — U.S. global hegemony in a unipolar world — is over. In a world where competing blocks are emerging, there are a few clear outcomes. We continue to believe that a commodity supercycle is likely to occur during the balance of this decade, with the proximate cause of this cycle being the development of strategically secure supply chains of critical commodities. Much like the prior cycle was driven by Chinese urbanization, this one will be driven by the West attempting to strategically source its commodity needs from geopolitically friendly locales.

In this new world, which looks much like the pre-1990s old world, we believe tariffs are going to be used by Trump 2.0 to attempt to change behavior, not necessarily to raise revenue. Both U.S. companies and many of our global partners are the primary targets. The incoming administration wants to see all manner of manufacturing relocated to the United States and we take them at their word that they are serious about using policy to achieve this goal. U.S.-based firms are going to be encouraged to reshore production. We believe that the goal vis-à-vis China is likely to reach a "grand bargain" in which Chinese companies set up manufacturing facilities in the U.S. in exchange for tariff relief. As for the Europeans, we expect tariffs to be used in a carrot-and-stick approach to encourage a larger commitment to their own unified defense capabilities.

Overall, we think one thing is clear. Geopolitical uncertainty going forward has risen relative to the past 10–20 years, suggesting that market multiples should move lower. Currently, the market does not share this view, leaving us cautious though not bearish as opportunities exist such as those identified above. Time will tell if we are right.

2025 U.S. Fixed-Income Market Outlook

What is the outlook for inflation and interest rates?

With inflation moderating and the U.S. Federal Reserve ("Fed") transitioning to an interest rate cutting cycle, bonds are poised to perform well in 2025. The U.S. election's outcome will likely add to pro-growth policies that will further support risk assets such as corporate bonds, from a fundamental perspective. Most fixed-income asset classes continue to provide high levels of yield, good news for bond investors who are searching for income and total return opportunities.

The two main risks to our outlook are centered around the enactment of large-scale tariffs and a reacceleration of inflation.

In 2024, the macroeconomic landscape improved as inflation fell, unemployment remained relatively low, GDP growth stayed firm, corporate profit margins strengthened, and central banks began cutting policy rates. We believe that success in the coming year will be achieved by choosing fixed-income sectors that will deliver strong price returns in a falling rate environment.

As we head into the new year, we believe that the Fed will continue its non-recessionary rate-cutting cycle and will work to lower the federal funds target rate to below 4% from the current range of 4.50 – 4.75%. The level where interest rates eventually land depends on how high rates must be to balance a healthy labor market and modest inflation. The pace of future interest rate cuts will be dependent on economic data and fiscal policy.

Stimulative fiscal policies may add to near-term inflationary pressures, resulting in fewer rate cuts and a yield curve that remains at elevated levels. Our base case is for three rate cuts for 2025; however, if growth shows signs of deceleration, the Fed will have the option for further policy easing. If inflation shows signs of moving higher, the Fed will have to limit the number of rate cuts and change the course of the pace of future rate cuts.

If we focus on the yield curve, the 10-year/3-month and 10-year/2-year Treasury yield curve spreads have un-inverted rapidly as the Fed has proceeded on its easing campaign. We have reported on the yield curve inversion and its market implications since the curve first inverted (refer to ["Key Questions: The Yield Curve Has Un-inverted. Now What?" | Key Wealth](#)). After the 10-year/3-month and 10-year/2-year curves both hit their maximum inversion points in the early summer of 2023, the yield curve has been steadily steepening. We anticipate that the yield curve will continue to steepen into 2025. We expect investor demand for longer-dated bonds will increase when the 10-year Treasury note yield moves above 4.5%. At this stage of the cycle, selectively adding duration to fixed-income portfolios will allow investors to "lock in" yields at attractive levels.

For inflation, the main questions are: 1) will inflation reach the Fed's 2% annual goal? And 2) how much would the Fed tolerate any deviations from their stated target inflation goal? The overall inflation rate is expected to decrease to 2.3% by the end of 2025. This is a significant decline from the exceptionally high inflation rate of 8% experienced in 2022. The Fed's preferred measure of inflation, the core Personal Consumption Expenditures (PCE), is projected to slow to approximately 2.1% by late 2025, close to the Fed's 2% inflation target goal.

However, if trade policy results in across-the-board tariffs, the PCE forecast could rise to an estimated level of 3%. The Fed is anticipated to continue its efforts to manage inflation through monetary policy adjustments, which includes interest rate cuts to support economic growth. Trends in home prices may help inflation return to target should shelter costs cool in 2025. Factors such as supply chain constraints, labor market conditions, and geopolitical tensions can also impact inflation rates.

Jobs data in 2025 is the wildcard and will continue to be scrutinized by the Fed and market participants alike. For some time now, the unemployment data has exceeded expectations. The job market has cooled; however, not to a level to cause a stall in economic growth. Since July of 2024, the unemployment rate has trended lower to 4.1%, building support for the case that the U.S. economy can achieve a “soft landing,” with elevated rates not resulting in a recession. It is our expectation that the unemployment rate will move slightly higher next year, giving the Fed further confidence to continue on its rate-cutting path.

There are two scenarios where the Fed would need to adjust its approach to rate cuts. First, if inflation begins to consistently trend higher, the Fed may need to pause its rate-cutting cycle and stabilize rates in the 3%–4.0% range. Second, if there is sustained labor market weakness, the Fed would be compelled to cut rates aggressively.

How low can credit spreads go?

Turning our attention to the credit markets, corporate credit spreads have reached multi-decade lows, and we believe there are reasons for them to remain at or near these levels in 2025. As the Fed cuts rates, financial conditions should ease, providing support to the credit markets. Still, we are taking a slightly more defensive view on corporate credit, given how far spreads have tightened this year. With investment-grade credit spreads unlikely to significantly narrow further, returns in 2025 will be driven by the income (“carry”) on the asset class and the interest rate effects as the Fed continues cutting rates. It will be important to use active security selection and focus on high-quality credit with a risk-reward case for adding duration. We believe that the best opportunities on the investment-grade credit curve are between five and 10 years (the intermediate part of the credit curve). Relative to broad bond indexes, our sector recommendations are:

2025 Sector Recommendations

Sector	Recommendation
Financials	Overweight
Communications	Overweight
Healthcare	Underweight
Utilities	Overweight
Autos	Overweight
Basic Industry	Underweight
Retail	Underweight

Definitions:

Overweight: Credit fundamentals are stable and/or have room for upside. Valuations are favorable.

Underweight: Credit fundamentals are subpar. Valuations are rich.

Investment-grade corporations have issued more than \$1.4 trillion in U.S. bonds in 2024, putting them on track for the second-busiest year for issuance. The demand for investment-grade corporate bonds remains strong and the supply of new bonds has been digested very well, even in an environment of tight credit spreads. We expect 2025 to be another year of record bond issuance as the economy and corporate balance sheets continue to grow. The demand for investment-grade corporate bonds should satisfy the expected elevated level of supply as money rotates from cash instruments into investment-grade securities. As rates continue to fall, investors will be rewarded by picking up debt securities with higher yields, or coupons.

The high-yield credit market has posted strong returns in 2024 as credit spreads reached their narrowest level in almost 20 years and as the high-yield default rate stabilized. Keeping valuations in mind, the market may be overlooking the potential for credit weakness going forward. We believe that a cautious approach to high yield is warranted. Weaker high-yield companies are more likely to face credit deterioration as economic volatility potentially rises. The renewed risk of tariffs offsets some of the expected benefits from lower tax rates and reduced regulation. When tariffs were implemented in 2018, growth concerns rose, and high-

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yield corporate credit spreads widened. The fundamental backdrop is different now for borrowers because interest rate levels are much higher. There is also a growing private credit market that has kept public bond and loan supply tight, distorting traditional measures of credit stress. More private credit results in less supply for public debt, which has skewed visible risk premia across the board. The difference between high-yield and investment-grade risk premia, which gets compressed by indiscriminate risk taking, has reached levels not seen since 2021. At these levels, we recommend higher-quality borrowers that are more likely to withstand an increase in market volatility.

How large can the nation's deficit grow?

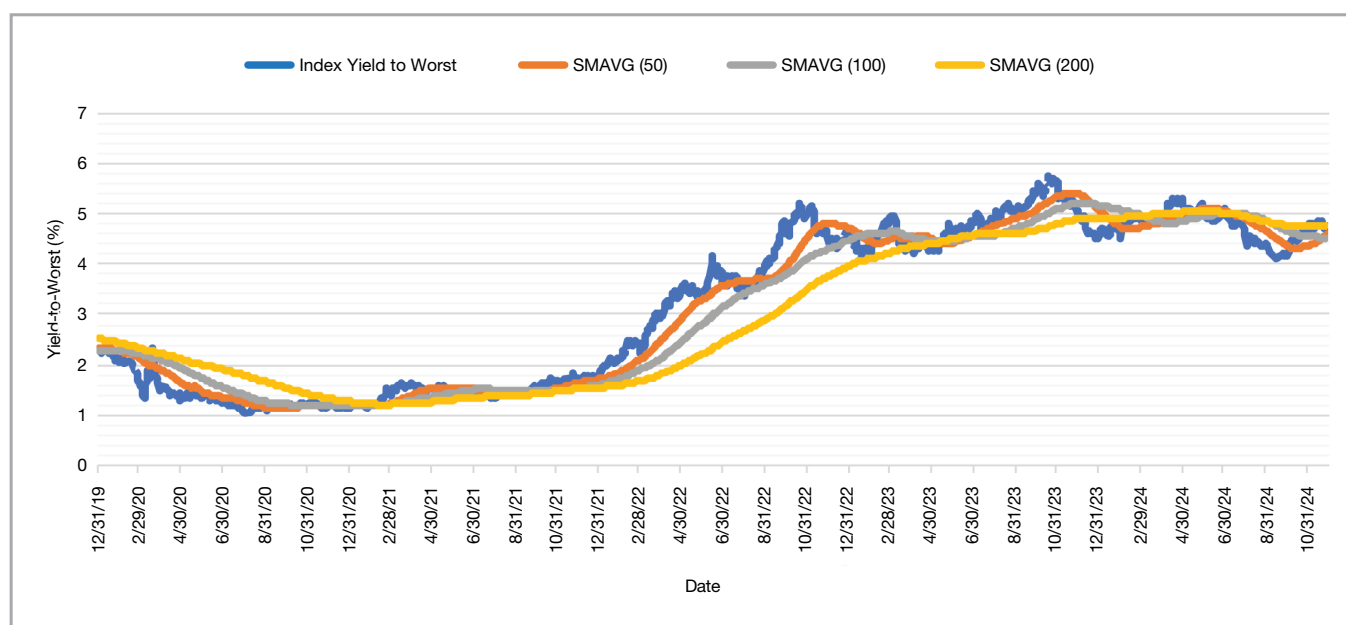
According to projections from the Congressional Budget Office (CBO), the U.S. national deficit in 2025 is expected to reach approximately \$2 trillion, which is a significant increase from prior years. The deficit represents 7% of GDP in 2024 and 6.5% of GDP in 2025. Relative to the size of the U.S. economy, debt is expected to grow significantly over the next 10 years as increases in interest costs and mandatory spending outpace decreases in discretionary spending and growth in revenues. The new political administration will need to confront these lofty deficit projections. Net interest spending increased by \$223 billion from fiscal year 2023 and has nearly tripled since 2020. The new fiscal policies

that will come into focus in 2025 will have to take into account the burden of the U.S. national debt and interest spending and place reforms that reduce the further growth of the national debt. Ten-year yields are expected to trade between 3.25% and 3.75% at the end of 2025; however due to spiraling deficit concerns, yields have the risk of being much higher and for longer.

What are the risks, and what are the opportunities?

Bond investors are entering 2025 on a strong note with yields at attractive levels and the Fed in a supportive, rate-cutting cycle. Bonds are well positioned to be portfolio diversifiers with starting yields still above their 20-year moving average in most sectors (see Figure 2). The tailwind of future rate cuts should add to total return propositions through further decline in yields from their current levels. It is our expectation that the yield curve will continue to steepen as rates move lower. The 10-year Treasury yield is expected to trade between 3.25% and 3.75% by the end of 2025, providing investors with good opportunities to take advantage across interest-rate-sensitive fixed-income sectors for the coming year. The upside risks to our projections for the 10-year Treasury yield are 4.5% – 5% due to potential changes in fiscal policy and deficit sustainability as well as international trade implications.

The Bloomberg Barclays Aggregate Bond Index (Yield-to-Worst): Yields remain higher than long-term averages



Source: Bloomberg, L.P.

In the year ahead, we expect investment-grade corporate bonds to continue to outperform U.S. Treasuries due to attractive yields, offering compelling risk-adjusted returns. We feel that inflows from money market funds and other cash-like instruments will further support investment-grade credit. Risks to this outlook center around an economic recession, an escalation of geopolitical tensions, and a worsening fiscal deficit. However, high-quality corporate bonds will provide some insulation from such exogenous market events.

We have a more cautious stance toward the high-yield sector as valuations may not fully reflect future economic uncertainties. Given the limited credit risk premia, a potential economic slowdown or increased credit risk scenario could see moderate spread widening. High-yield sector performance will depend on factors such as sector resilience, debt funding costs, and macroeconomic pressures. The B-rated segment within high yield will offer the most relative value given its stronger corporate balance sheets and the ability of these issuers to fund expenses at current elevated interest rates. Returns will primarily come from coupon income, indicative of limited potential for capital gains at current valuations.

There are also opportunities in municipal bonds considering the effect of taxes, particularly in high-tax states, where tax equivalent yields could provide investors with further incentives in 2025. Municipal spreads are expected to tighten modestly over the next 12 months and default rates are projected to remain low. Demand for municipal bonds should continue to outpace supply, supporting muni/treasury ratios, particularly in the shorter tenors along the curve. Key risks to our forecast for municipal bonds include changes in Fed policy and potential tax/regulatory changes.

Overall for 2025, we remain optimistic for fixed income given the expectation of further rate cuts and a “soft landing” base case scenario.

Bonds offer attractive opportunities despite tight credit spreads, especially over longer holding periods. The upside scenario is the potential for growth to be stronger than expected, with falling inflation and rate cuts providing a “Goldilocks” environment for risk assets. We remain vigilant of potential downside risks to our assessment if a hard landing were to materialize and/or inflation were to significantly reaccelerate. It will be important to monitor the pace of rate cuts given the potential implications for the U.S. deficit in the face of new fiscal policies. We advocate for managing risks through asset class selection and finding opportunities that support stable, income-generating assets given the potential of economic uncertainties and current valuations.



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