INSIGHTS AT THE INTERSECTION OF WEALTH, FAMILY, AND VALUES

TURNING THE PAGE: The Economy and Markets in 2025

Winter 2025

InvestorView

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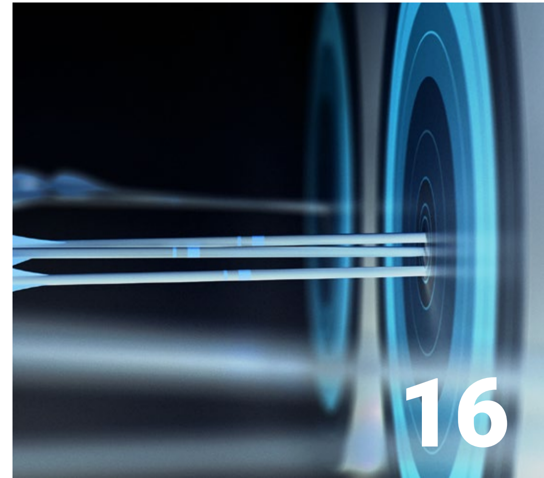

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Dear clients and friends,

We hope that your 2025 is off to a successful start!

In the feature article of this issue of *InvestorView*, BBH Partner and Chief Investment Strategist Scott Clemons covers our economic outlook for 2025.

In another article, BBH Partner and Chief Investment Officer (CIO) Justin Reed, Deputy CIO Ilene Spitzer, and Head of Client Portfolio Management and Strategy Niamh Bonus discuss the Investment Research Group's portfolio positioning amid the potential volatility, risks, and opportunities in the year ahead.

We also hear from Fixed Income Product Specialist Tom Brennan about the current credit market's implications for the pillars of our investment process, how it affects our clients' portfolios, and how it aligns with our clients' priorities of income and safety.

Finally, Principal Brett Sovine discusses an appealing savings option for family health-care costs: the health savings account.

We hope you enjoy this issue. If you have any questions about the topics covered, please do not hesitate to reach out.

Best regards,

G. Scott Clemons, CFA
Partner
Chief Investment Strategist

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TURNING THE PAGE:

The Economy and Markets in 2025

G. Scott Clemons
Partner
Chief Investment Strategist

To paraphrase the great American philosopher Mark Twain, the rumors of the death of this economic cycle have been greatly exaggerated. Close readers will recall that most economists (including your faithful correspondent) expected a modest recession to materialize in 2023, and with good reason. The economic sugar high of pandemic-era fiscal stimulus had come to an end; the yield curve inverted, with the spread between two- and 10-year yields widening out to over 100 basis points (bps); and the index of Leading Economic Indicators (LEI) was flashing red.[1] Despite these time-tested indications of economic stress, the economy didn't get the memo. Real gross domestic product (GDP) grew 3.2% in 2023, and likely ended 2024 at a similar pace.

Economists got it wrong, but what went right? Simply put, people keep spending money, and personal consumption remains the primary engine of economic activity.

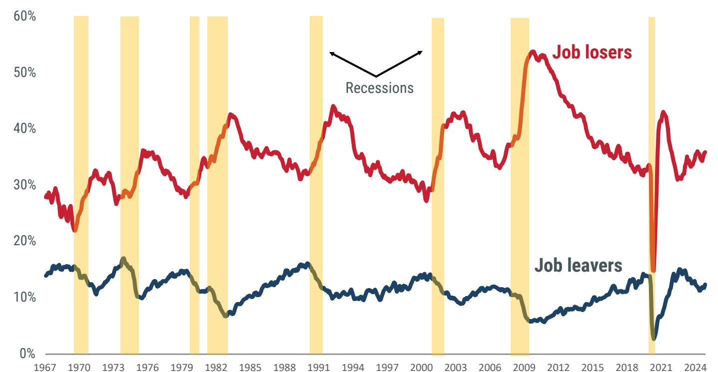
As we turn the calendar page, the U.S. economy starts 2025 on a strong note, yet economic storm clouds linger on the horizon. This tailwind of personal spending and household financial health may begin to wane, just as some policies of the Trump administration may introduce more economic uncertainty, and even reignite inflation. There may yet be bad economic weather ahead. Investors don't need to open their umbrellas quite yet, but it would be a good idea to keep them within arm's reach.

The state of household finances

People spend money out of a sense of economic well-being and job security, which is why the labor market is so important to spending and sentiment. Jobs and paychecks create not only the ability but also the psychological willingness to spend money. The labor market is healthy: The U.S. economy added over 2.2 million jobs in 2024, ending the year with a strong gain of 256,000 jobs in December. Despite this tailwind, there are increasing signs that job growth will slow in 2025.

The graph nearby offers a snapshot of the composition of unemployment. For the past several months, the number of people who are unemployed because they got fired has been on the rise, while the number of people who quit their jobs voluntarily has declined. The negative correlation between these two trends is evident in the graph. Historically, an environment of more people being fired while fewer people are quitting has signaled rising economic stress. This doesn't necessarily presage the end of this labor market boom, but it does imply slower wage growth and less job security going forward.

Unemployment by reason

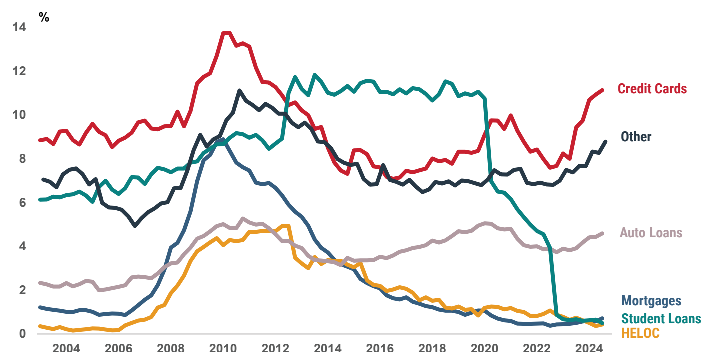


Source: Bureau of Labor Statistic, BBH Analysis.
Data as of December 31, 2024.

At the same time, household finances are showing incipient signs of stress. Consumer debt is at an all-time high of $18 trillion, while the personal savings rate, at 4.4%, is close to an all-time low. Household income and assets have risen at a faster pace than debt, so the economy is not threatened by a household debt bubble like the one that sparked the 2008 global financial crisis. There is, however, not much of a cushion in household finances.

Debt delinquencies are the clearest sign of household financial stress, and credit cards tend to lead the trend. Credit card delinquencies have been rising sharply since the middle of 2023, and over 11% of total outstanding balances are now more than 90 days overdue. This can be an early warning sign for future household stress, as a strapped borrower is likely to miss a few credit card payments before missing a mortgage or car payment. We will watch these developments closely throughout 2025 to see if credit card delinquencies continue to rise, and (more worrisomely) whether this stress leaks into other categories of consumer debt.

Consumer debt delinquencies >90 days



Source: New York Fed Consumer Credit Panel, BBH Analysis.
Data as of December 31, 2024.

The expansionary ripple effects of fiscal and monetary stimulus continued well beyond the end of the pandemic and lasted far longer than the extraordinary economic measures that accompanied the crisis. There is a more uncertain path forward, and we will learn in 2025 how much of a hangover might follow the fiscal party of the past few years.

Trump 2.0

The return of Donald J. Trump to the White House has introduced the same sort of policy and economic unpredictability that characterized his first administration. Every president has difficulty translating campaign promises into political reality, and our 47th president's experience will be no different. President Trump will accomplish through executive orders those things he can enact on his own authority, but will need to manage razor-thin margins in congress to extend the 2017 Tax Cuts and Jobs Act (TCJA) and implement wide-ranging cost cuts in government spending, two priorities of his second term. He understands that he might lose these congressional majorities in the 2026 mid-term elections (as most presidents do), so the legislative calendar is tight.

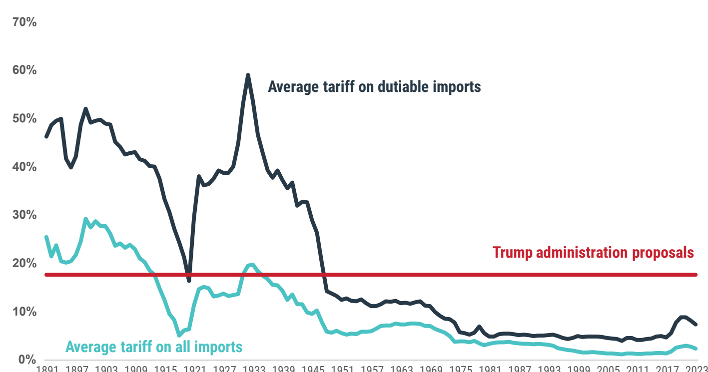
We ultimately think that President Trump will succeed in extending the TCJA, perhaps with some modifications to mollify the few remaining fiscal hawks in Congress, and that he will furthermore succeed in rolling back some of the regulations imposed by the Biden administration. These would be supportive of economic activity and corporate earnings. However, two areas that might pose some unintended economic disruptions, and perhaps even push inflation higher, are trade and immigration policies.

Trade and tariffs

President Trump has made clear his intent to use tariffs more broadly than any administration since World War II. Up until the middle of the 20th century, tariffs were a consistent backdrop to the U.S. economy. From 1900 to 1945, the average tariff applied to dutiable goods was 39%, but then fell to 8% from 1946 to 2024. This reflects a prolonged opening of global markets and the establishment of multinational initiatives such as the General Agreement on Tariffs and Trade (GATT 1948), the World Trade Organization (WTO 1994), and the North American Free Trade Agreement (NAFTA 1994).

Every president since George Washington has used tariffs, most often to level a playing field deemed unfair by government subsidies, or (ironically) to protect nascent American industries. President Trump used tariffs tactically during his first administration, but now proposes a much broader application to encourage the growth of U.S. industry and manufacturing, raise revenues to help pay for an extension of the 2017 tax act (among other things), and to act as both carrot and stick to incentivize the behavior of trading partners. His proposals have varied over time, but center on a blanket tariff of 20%, plus a surcharge to bring tariffs on Chinese imports up to 60%. This would return the American tariff regime to a level not seen since the middle of the 20th century.

A not-so-brief history of U.S. tariffs



Source: U.S. Department of Commerce, U.S. International Trade Commission, BBH Analysis. Data as of November 30, 2024.

Tariff hikes would almost certainly prompt retaliatory tariffs on American exports, encourage cheating (for example, forged origins or sources), and ultimately cost consumers more money. The global network of manufacturing, outsourcing, and supply chains that defines the global economy has developed over an 80-year period of relatively low tariffs, and readjusting to a new economic reality of sharply higher tariffs would be disruptive and expensive in equal measure.

The revenue opportunities from broad tariffs are limited, at least in the grand scheme of the American economy. In 2023, the U.S. economy imported a little over $3.8 trillion, over one-third of which came from Mexico, China, and Canada. Applying blanket tariffs of 20% across this whole spectrum (and 60% for China) yields a hypothetical revenue of $944 billion, a figure that does not take into account cheating, substitutions, and reciprocal tariffs. In reality, receipts would likely be far lower than this simple calculation. Compare this figure to the overall U.S. fiscal deficit of $1.7 trillion and individual tax revenues of $2.2 trillion for the same period.

Hypothetical revenues from U.S. tariffs

Country of Origin	2023 Imports ($ billions)	% of Total	Proposed Tariff	Implied Revenue ($ billions)
Mexico	480.1	12.5%	20%	96.0
China	448.0	11.7%	60%	268.8
Canada	429.6	11.2%	20%	85.9
Germany	163.0	4.3%	20%	32.6
Japan	151.6	4.0%	20%	30.3
South Korea	119.7	3.1%	20%	23.9
Vietnam	118.9	3.1%	20%	23.8
India	87.3	2.3%	20%	17.5
Ireland	82.7	2.2%	20%	16.5
Italy	75.2	2.0%	20%	15.0
Rest of World	1,670.9	43.7%	20%	334.2
Totals	**3,826.9**	**100.0%**		**944.6**

Source: Bureau of Economic Analysis, BBH Analysis. Data as of December 31, 2023.

Furthermore, import tariffs are paid by American individuals and companies. The U.S. does not have taxation authority over foreign citizens and companies, and any attempt to create such an external taxation scheme would result in higher prices as importers incorporated these new tariffs into their cost structure. To be economically precise, higher tariffs don't necessarily lead to higher inflation, as defined by a sustained upward trend in prices. The economic impact of tariffs looks more like a one-off price shock, but a shock that could ripple through a globally interconnected economy into higher prices across a wide range of goods and services.

The foundation of the post-World War II economic boom in the global economy was the opening of international markets and the rise of global trade. No one wins a trade war.

Immigration

Immigration has long been the most heated and controversial topic in politics: It is an emotional issue, as well as a legal, ethical, cultural, and social one. Immigration is also an economic issue, a fact that often gets lost in the political rhetoric. In the long run, an economy can only expand in line with the growth of its labor force, plus the productivity of that labor force. The U.S. has historically enjoyed a tailwind of population and labor force growth, but these trends are changing. From a peak of 3.75 children per woman in 1959, the U.S. fertility rate has now dropped to 1.62 – below the replacement rate. This implies that we will need to borrow from the population growth of other nations if we are to continue expanding our labor force and our economy. Hence the necessity of getting immigration right.

It is a rare point of agreement in Washington, D.C., that we're not currently getting it right, although Democrats and Republicans disagree on *how* to address the issue. The first two points of Trump's 20-point plan as a candidate were to "seal the border and stop the migrant invasion" and "carry out the largest deportation operation in American history." His focus and stance are quite clear, and the appointments he has made signal his intent to carry through on these campaign promises.

It is frustratingly difficult to quantify the potential impact of this on the U.S. labor force, since by definition the focus is on undocumented people. Various estimates place the number of undocumented residents at 10 million to 12 million, with roughly 6 million to 7 million of these people in the labor force. Polls show widespread support for deporting people who commit crimes or otherwise abuse the system, but our concern is that broad deportations could disrupt the portion of these undocumented workers who are economically productive. Although undocumented, many of these workers do pay into the U.S. tax system. The Institute on Taxation and Economic Policy found that workers without Social Security numbers (a proxy for the lack of other documentation) paid $96.7 billion in federal, state, and local taxes in 2022, $25.7 billion in Social Security taxes, $6.4 billion in Medicare taxes, and $1.8 billion in unemployment insurance.

Labor market supply and demand

Source: Bureau of Labor Statistics, BBH Analysis. Data as of November 30, 2024.

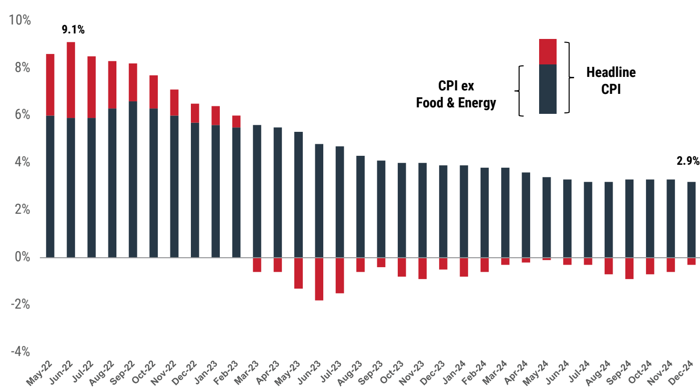
[R]eadjusting to a new economic reality of sharply higher tariffs would be disruptive and expensive in equal measure.

This potential forgone tax revenue isn't the whole story. Of far larger import, mass deportations would widen the imbalance of labor market supply and demand, creating shortages of workers and driving up wages. The U.S. economy ended 2024 with close to a million more job openings than people available to fill them: Deportations threaten to amplify this imbalance. If this were to happen, the pain would fall primarily in agricultural and construction sectors, adding to food inflation and the cost of housing.

Monetary policy

This interplay between economic activity and inflation makes the task of the Federal Reserve that much more difficult. Recall that the Fed's job consists of the pursuit of economic growth within a context of price stability. This so-called "twin mandate" has been easy to fulfill for most of the past 15 years, as inflation remained dormant (until a few years ago), allowing the Fed to keep interest rates lower for longer. The pandemic ended all that. The surge in inflation forced the Fed to hike interest rates aggressively, although various Fed governors claimed that inflation was "transitory" and that interest rates would fall once the inflationary transition ebbed. This narrative played out, as inflation (as measured by the Consumer Price Index [CPI]) peaked at 9.1% in June 2022 and dropped to 2.9% by December 2024.

Inflation

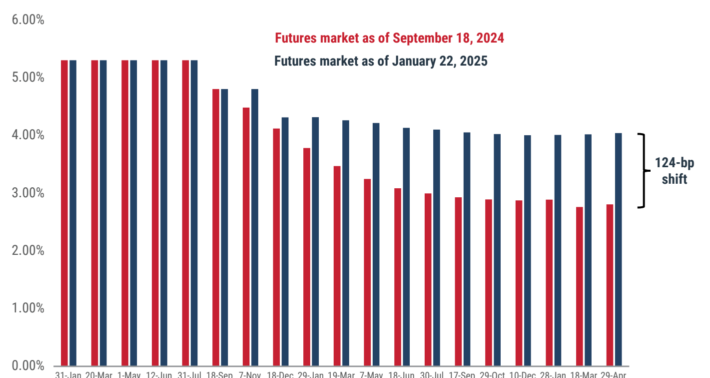


Source: Bureau of Labor Statistics, BBH Analysis.
Data as of December 31, 2024.

This narrative may be shifting once again. Inflation (and core inflation, in particular), has proven stickier than expected, and some of the policy initiatives outlined above may exert additional upward pressure on prices. The Fed's job is no longer easy as it contends with persistent inflation and the possibility of slower economic growth. Interest rates might wind up higher for longer, or at least for longer than the market anticipated only a few months ago.

The fed funds futures market reflects this evolving narrative. On September 19, 2024, the Fed lowered interest rates by 50 bps, confident that "inflation is moving sustainably toward 2 percent." At that time, the market anticipated that the Fed would lower interest rates an additional 175 bps to 200 bps by the end of 2025, as inflation continued to move closer to the Fed's desired target. These expectations have narrowed sharply: As of late January, the futures market now expects only 25 bps to 50 bps of cuts by year-end, and some economists are whispering that the Fed could find itself in the position of needing to raise rates if inflation surges.

Fed funds futures markets



Source: Bloomberg, BBH Analysis.
Data as of January 22, 2025.

Rebalancing is a critical ingredient to portfolio success, and we encourage investors to do so, particularly after such a strong rally in U.S. equities.

The most important Fed meeting of the year is likely to be March 19. We (and the Fed) will get two more months of labor market and inflation data before this meeting, as well as two months of seeing how successful the Trump administration is in turning proposals into policy.

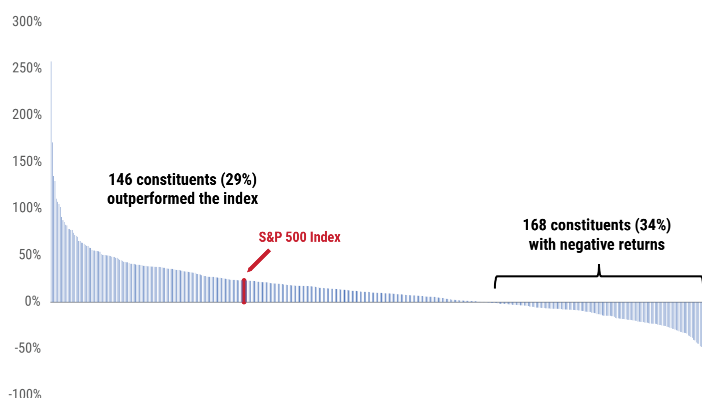
The shifting narrative on monetary policy and interest rates is likely to be the biggest source of financial market volatility in 2025.

The market

The past two years have been good for the broad equity market. The S&P 500 rose 27% in 2023 (total return), followed by a 25% gain in 2024. Tempering this good news somewhat is the well-reported feature that these gains have been narrowly concentrated in a small handful of stocks. Indeed, over half of the market's gains last year were due to the large technology stocks colloquially known as the Magnificent Seven.[2]

There is both good and bad news in this dynamic. The bad news is that narrowly led markets tend to be volatile: A bad day for Nvidia or Apple (who together account for over 13% of the capitalization-weighted S&P 500) is mathematically a bad day for the index. What goes up occasionally goes down.

2024 return for S&P 500 constituent members



Source: Bloomberg, BBH Analysis.
Data as of December 31, 2024.

The good news for active investors is that the rally of the past few years has left plenty of companies behind: 168 stocks – over one-third of the index by name, not weight – posted negative returns in 2024. There was, in other words, a quiet bear market hidden in last year's otherwise impressive returns. This is not to say that all these market laggards are good investments. It is to say that investment opportunities abound for the patient, value-focused investor willing to adopt a contrarian stance.

We also continue to find compelling opportunities in the broader equity market, including smaller- and mid-capitalization companies as well as equity markets outside the U.S. The large-cap S&P 500 has done so well for so long that it can be hard to justify the inclusion of other types of equity in a portfolio. This won't always be the case: Reversion to the mean is a powerful force in financial markets, albeit a poor timing tool. Rebalancing is a critical ingredient to portfolio success, and we encourage investors to do so, particularly after such a strong rally in U.S. equities.

If the above economic scenario of stickier inflation unfolds, and interest rates remain higher for longer, so, too, will opportunities in fixed income remain attractive. For those investors with longer time horizons and the willingness to forgo liquidity, private debt in particular offers interesting opportunities, as private pools of capital fulfill financing needs that banks are increasingly reluctant to provide.

Conclusions

There is a difference between risk and uncertainty. Rolling a die is the classic example of risk-taking: Like flipping a coin or drawing a hand of cards, you don't know what you're going to get. You do, however, know the range of possible outcomes (one through six), along with the probability of each outcome (1/6 or 16.7%). Uncertainty is different, as if you don't know how many faces are on the die, or what's on them. Both the range of outcomes and the probability are unknowable.

Investors live with both risk and uncertainty . They are features, not bugs, of markets. The likelihood of economic and policy change in 2025 offers heightened uncertainty, which will likely translate into heightened price volatility. We believe that a focus on fundamental analysis and a deep appreciation for value are essential in any investment environment, and they are critically essential in this one. ■

[1]Basis point (bp) is a unit that is equal to 1/100th of 1% and is used to denote the change in price or yield of a financial instrument.

[2]The Magnificent Seven stocks are Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

References to specific securities, asset classes, and financial markets are for illustrative purposes only and are not intended to be and should not be interpreted as recommendations.

Risks and Responses: Our Portfolio Positioning for 2025

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Inflation. High valuations. Geopolitical and regulatory risks. Artificial intelligence (AI). Volatility. These five risks are top of mind as 2025 unfolds. Here, we dive into each of these risks and our response to them. Though they are certainly worth careful consideration, we believe we are well positioned to navigate them, and in fact, some of these "risks" may represent opportunity.

Inflation and interest rates

Inflation is one of the most pressing risks facing all individuals and institutions seeking long-term capital preservation. An inflation rate of 3% over 30 years results in a nearly 60% decline in purchasing power. In dollar terms, $1 million today will be worth $412,000 in 30 years at a 3% inflation rate. A failure to outperform inflation long term represents an impairment in real wealth.

We are closely monitoring the Trump administration's potential policies that could result in a rebound in inflation in the U.S., including higher tariffs on imports and a more restrictive immigration policy, particularly including increased deportation. Should a rebound in inflation occur, we expect the Federal Reserve to cease monetary easing and consider increasing the fed funds rate, resulting in higher interest rates.

We are also monitoring the U.S. federal debt and deficit. The U.S. budget deficit grew to $1.83 trillion for fiscal year 2024, and interest on the federal debt exceeded $1 trillion. The U.S. national debt reached $35.5 trillion, and debt-to-GDP reached 123%. Generally, a higher debt-to-GDP ratio indicates that a government will have greater difficulty in repaying its debt and also implies the potential for higher interest rates, as borrowing can become more expensive.

While we do not expect any significant changes regarding debt levels and the deficit in the coming years, as long-term investors we account for the risk of higher inflation and interest rates by tactically allocating to the following strategies:

Sticking with short- and medium-duration assets

Within fixed income, we have maintained a portfolio of short- and medium-duration high-quality credits that can produce competitive returns across many different inflationary regimes. We are avoiding longer-duration credits (those longer than 10 years), as we are being adequately compensated in short- and medium-duration assets.

The larger the federal budget deficit and debt level, the greater the bond risk premium is likely to be, which suggests higher yields on Treasuries. Staying with short- and medium-duration credits will position our portfolio to capture potential rate increases more quickly while helping to minimize rising yields' price impact on longer-duration fixed income.[1] We are also invested in securities that we expect to be resilient in an uncertain future.

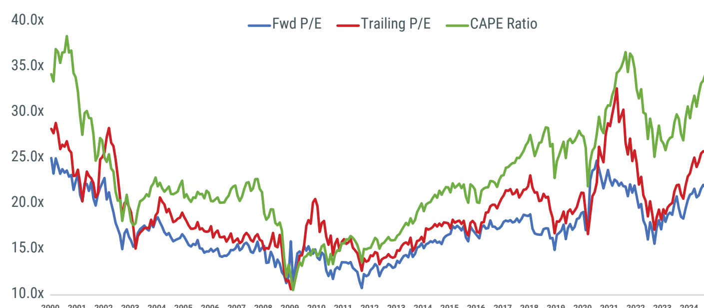
Allocating to public and private equities

If higher interest rates are the most tangible near-term impact of higher inflation and increasing debt and deficit levels, our meaningful allocation to long-term high-quality public equities with pricing power and private equity is the best portfolio solution. Adding alternative assets to a portfolio can provide much-needed return enhancement and inflation protection as well as diversify exposure. Over the past few years, we have been focused on adding allocations to several "independent return" strategies that seek to produce equity-like returns with low beta[2] (and correlation) to equity markets. We have also added exposure to private investments where we seek to capitalize on market inefficiencies and an illiquidity premium to generate greater returns than those in public markets. Within private markets, we have exposure to real asset investments that can hedge against inflation.

High valuations and narrow market leadership

The S&P 500 hit 57 all-time closing highs during 2024, prompting a deluge of questions regarding market valuations. Based on trailing price-to-earnings (P/E) ratio, forward P/E, and the cyclically adjusted price-to-earnings (CAPE) ratio,[3] the S&P 500 is trading at levels not seen since the dot-com bubble (excluding the COVID-19 period).

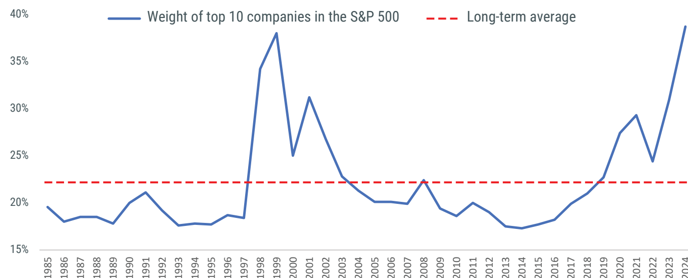
S&P 500 trading at dot-com bubble levels*



Source: Bloomberg.
Data as of December 31, 2024.
**Excluding COVID-19 period.*

We are also witnessing unprecedented levels of concentration in the S&P 500. The performance of mega-capitalization companies, such as the FAANG[4] stocks and, most recently, the Magnificent Seven,[5] drove S&P 500 returns in 2024. The last time we saw the top 10 holdings comprise such a large share of the index was in 1999.

Market concentration is at multidecade highs



Source: FactSet.
Data as of December 31, 2024.
Based on calendar year-end weight.
Long-term average based on weight from 1985 to 2024.

Focusing on quality companies through active management and diversification

While high market valuations are associated with an increased probability of a market correction, they do not provide information about *when* a market correction will occur. We are highly attuned to market valuations, but we do not use them to move in and out of the stock market.

Additionally, we do not own the index. Our public equity portfolio does not look like the S&P 500, in that it is higher quality (that is, fundamentals are better) and more diversified (with high-quality companies outside of the U.S.) and has a smaller market capitalization. Our public equity portfolio is more correlated with the smaller-capitalization S&P 500 Equal Weighted Index than the market cap-weighted S&P 500. We are comfortable with this positioning long term, as today the S&P 500 trades at a 27% premium to its equal-weighted version and sits 1.6 standard deviations[6] above its historical average valuation (compared with the Equal Weighted Index trading at its historical average).

Historically, the Equal Weighted Index has outperformed the market cap index during roughly 80% of rolling 10-year periods, by an average of 2 percentage points. As a result, though our positioning detracted from relative results in 2024, we believe that our more diversified approach and smaller-cap bias (relative to the S&P 500) will be rewarded over a full market cycle, and we remain committed to our long-term approach.

Now is the time for active management, as active managers have tended to outperform in periods of widening market breadth. With market breadth at all-time lows, we expect to experience a broadening of performance across more companies, and we are positioned to respond. Our active management strategies tend to focus on high-quality companies with pricing power that:

- Sell essential, price-inelastic products and services or "products and services with strong pricing power"
- Exhibit strong free cash flow growth
- Have strong management teams who are exceptional capital allocators

While our public equity portfolio is diversified and performing well fundamentally, it is not immune to a market correction. This is why we are also diversified across asset classes, including the following:

- We look to **fixed income** in order to provide liquidity, stability, and yield in our portfolio.
- We believe increasing our allocations to **alternatives** can generate a return premium over public market equivalents over the long term while also providing portfolio diversification.
- We also believe that the current environment will provide additional tailwind for **private markets** in particular.
- With the Trump administration, we expect a trend toward deregulation, including reduced barriers for mergers and acquisitions activity. We think this bodes well for **private equity (PE),** particularly since PE valuations remain below 2019 to 2022 levels.

Geopolitical tensions and regulatory environment

Several geopolitical and regulatory risks are also front of mind. Geopolitically, we continue to monitor conflicts in the Middle East and between Russia and Ukraine. While highly unpredictable, we are also closely monitoring the relationship between China and the U.S. and China and Taiwan.

Given the higher U.S. tariffs, we are watching for a potential escalation in trade conflicts. We are also paying close attention to the Trump administration's comments and actions around some of the "big tech" companies, particularly as they relate to antitrust.

Bottom-up investing is one of the best tools for mitigating geopolitical and regulatory risks in a portfolio.

2016: Donald Trump	EXPECTATION	REALITY[7]
	Pro-energy, infrastructure boom; anti-tech • Trump's hostility toward Silicon Valley and his promises to rebuild U.S. infrastructure and roll back environmental regulations were anticipated to lead to a boom in materials, industrials, and energy sectors, while negative for technology.	S&P 500 industry total return during Trump: • Technology (269%), best performing sector • Moderate materials (75%) performance • Energy (-24%), worst performing sector
	Trade wars • Manufacturing and industrial sectors were expected to benefit from a U.S. manufacturing revival due to tariffs on Chinese imports.	Trade wars introduced higher costs rather than stimulating a manufacturing boom. • Relatively weak utilities (49%) and capital goods (53%) performance vs. S&P 500 (95%)
	Tax cuts and the financial sector • Trump's corporate tax cuts were expected to boost the financial sector significantly, as banks would benefit from lower taxes and a more business-friendly regulatory environment.	While low taxes supported earnings, financial stocks were impacted by other factors such as low-interest rates, which outweighed the positive effects of tax reform. • Financials sector ETF (68%) vs. S&P 500 (95%)

2020: Joe Biden	EXPECTATION	REALITY[8]
	Renewables and green energy • Biden had a strong focus on renewables like solar and wind.	Fossil fuel-related businesses have thrived, while renewables faced headwinds from rising interest rates and supply chain challenges. • Energy S&P 500 sector (278%) vs. solar ETF (-46%)
	Technology and regulation • With Biden's focus on tech regulation and antitrust measures, many expected large-cap tech companies and banks to face pressures, potentially slowing growth in the sector.	Despite regulatory scrutiny, the tech sector has been strong, with key contributors such as Apple, Nvidia, and Microsoft benefitting from demand in AI and cloud computing. • Semiconductors (314%), banks (116%), and technology (104%) all outperformed the S&P 500 (88%)
	Infrastructure, transportation • Biden focused on infrastructure spending and domestic manufacturing.	Supply chain pressures weakened infrastructure performance. • Relatively weak utilities (36%) and transportation (36%) performance vs. S&P 500 (88%)

Source: Bloomberg. Past performance does not guarantee future results. An investment cannot be made directly in an index. Performance percentages reflect total return. Numbers are rounded. S&P 500 reflects iShares Core S&P 500 ETF (IVV US). Financials Sector ETF security: XLF US Equity. Solar ETF security: TAN US Equity.

Staying true to bottom-up investing

Bottom-up investing is one of the best tools for mitigating geopolitical and regulatory risks in a portfolio. At the portfolio level, all investment strategies must compete for capital against all other investments. This helps us manage the risks embedded in a traditional asset allocation process that forces allocations to a variety of asset classes, including some that may not be attractive.

Monitoring strategic exposure

We are positioned today with *de minimis* exposure to Russian, Chinese, and Middle Eastern equities. We are underweight "big tech," or the Magnificent Seven, relative to the S&P 500, although we do have some exposure. Where we are invested, our managers have put tremendous effort into understanding potential ramifications of antitrust lawsuits.

Finally, the Trump administration has historically been less supportive of big tech and more supportive of smaller companies, including startups. We think private companies focused on AI, digital assets, and defense, among other sectors, will likely see more support from the new administration.

Policy matters, but its investment impact is difficult to predict and often overestimated. We will continue to invest with an eye toward potential regulatory risks and opportunities, but what is most critical is that we prepare our portfolio to be resilient in a variety of future permutations of world events.

Technological disruption

Disruptive technology, particularly AI, may make some products obsolete and impair the ability of certain companies to compete. Such technologies present both opportunities and challenges, and investors must work to identify which companies will benefit and which may suffer.

Preparing for the long and short term

We are believers in AI's long-term opportunity, but we are also keenly aware of the course of technological waves and valuations. Our best assessment of AI today is that the market may be overestimating its near-term impact but underestimating the long-term opportunity. Hyperscalers[9] in aggregate have spent around $175 billion in capital expenditures over the past four quarters, but they are estimated to generate only $20 billion to $25 billion in AI revenue this year. This suggests AI applications may not generate a net positive return on investment on infrastructure buildout for some time.

However, this type of investment is typical in technological waves and eventually results in an ecosystem that allows the technology to be incorporated into more workflows and be accessible to a wider group of adopters. Accordingly, we see AI as both an opportunity and a risk. We have meaningful exposure to AI companies within our portfolio and believe that if AI changes the world as much as many expect, our portfolio should benefit from this paradigm shift.

We segment our AI exposure into four main categories:

- **Tech hardware**, which includes semiconductor companies such as TSMC, ASML, and Nvidia. These companies play valuable roles in the supply chain of semiconductors required to use AI.
- **Tech AI infrastructure**, which includes companies developing large language models (LLMs), such as Alphabet, Meta, OpenAI, and Mistral. LLMs require major investment to train, and therefore, several "big tech" companies have a funding advantage.
- **Tech AI software**, which includes AI applications accessed through our venture capital portfolio, such as companies like ElevenLabs, OptimizerAI, and Anysphere.
- **Companies that seek to leverage AI** to streamline their processes, enhance their products and/or services, and increase their productivity. We believe that companies that are not thinking about how to leverage the technology risk being left behind.

Within public equities, in particular, our investment approach – which calls for investing in high-quality companies with sustainable business models and pricing power run by strong management teams – can provide an additional layer of protection against the risks of AI.

Volatility

Investors should prepare for volatility this year. We believe the cumulation of risks we are monitoring may lead to several "risk-off" periods in the future, particularly if there is a material impact to company fundamentals.

Leveraging volatility

As we have always said, volatility is our friend. We view an increase in volatility as an opportunity to capitalize on short-term discrepancies between value and price – we just need to position ourselves to take advantage of those mispricings when they occur.

The most important protection against volatility is focusing on the long term.

We have a slight overweight to cash in our current portfolio, and our managers are holding cash balances (a result of their bottom-up investment style) above historical averages, both of which can be leveraged to pursue attractive opportunities at the appropriate time. Cash also helps to serve as a ballast during the beginnings of any downturn before we can put it to work buying great investments "on sale."

The most important protection against volatility is focusing on the long term. The preservation and growth of overall portfolio value requires patience and a willingness to benefit from underlying portfolio diversification. Some portfolio components are designed to outperform in certain environments, and other strategies will do better in others. This is by design. All of the components are thoughtfully constructed to preserve and grow capital over the long term at the portfolio level.

Preserving and growing wealth is about time in the market, not timing the market. Staying invested is critical. Volatility will occur from time to time, but dramatically moving around one's asset allocation to try to time the market is a recipe for long-term capital impairment.

Conclusion

History doesn't repeat itself, but it rhymes. We continuously work to identify and address the many risks we see by focusing on fundamentals, valuation, portfolio construction, and risk management. It is nearly impossible to predict when a market correction will occur, and permanent impairment can arise by staying out of the market waiting for one. Instead, we choose to stay the course.

While the risks vary, our approach to preserving and growing your wealth remains consistent. We focus on investing bottom-up and worrying top-down. To achieve a balanced, resilient portfolio, we believe starting with a bottom-up approach is the first step in mitigating risk, as we can select quality investments based on deep fundamental analysis.

To learn more about our portfolio positioning, reach out to your BBH relationship team or a member of the Investment Research Group. ■

[1]Longer-duration fixed income will see a greater negative impact to price in a rising interest rate environment than short- and medium- duration fixed income, all else being equal.

[2]Beta is a measure of a portfolio's sensitivity to market movements. The beta of the broader equity market, as measured by the S&P 500, is 1.00 (Source: Morningstar).

[3]CAPE ratio is a variation of the P/E ratio that compares the index price to its average inflation-adjusted earnings for 10 years.

[4]FAANG stocks included Facebook (now known as Meta Platforms), Apple, Amazon, Netflix, and Google (now known as Alphabet).

[5]Magnificent Seven stocks include Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla.

[6]Standard deviation is used to measure the amount of variation around the average in a set of data.

[7]Trump period reflects 11/8/2016 to 1/20/2021.

[8]Biden period reflects 11/3/2020 to 11/7/2024.

[9]Cloud service providers that offer a large range of cloud computing and data solutions. Examples include Amazon Web Services, Microsoft Azure, and Google Cloud.

Past performance does not guarantee future results.

Opinions, forecasts, and discussions about investment strategies are as of the date of this commentary and are subject to change without notice. References to specific securities, asset classes, and financial markets are for illustrative purposes only and are not intended to be and should not be interpreted as recommendations.

Diversification does not eliminate the risk of experiencing investment losses.

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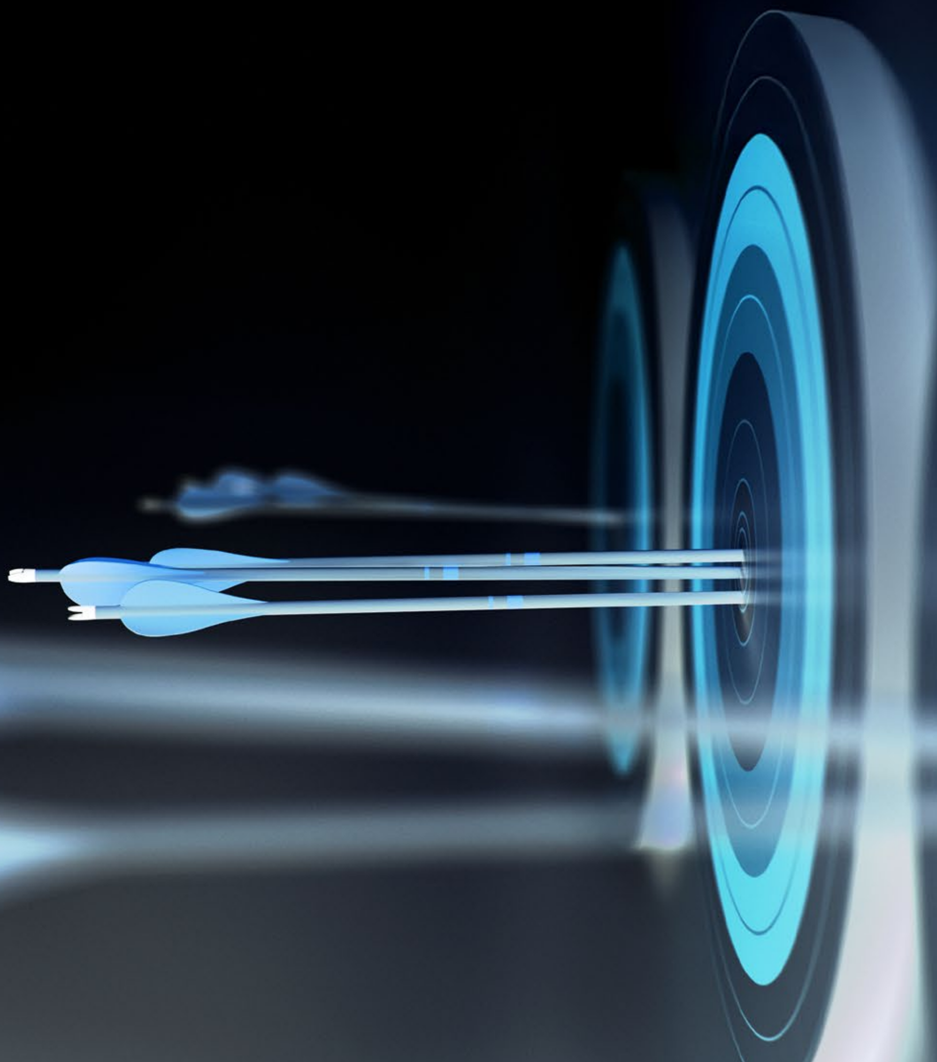
What We Believe: Credit Investing in a 'Priced-to-Perfection' World

Tom Brennan
Vice President
Fixed Income Product Specialist

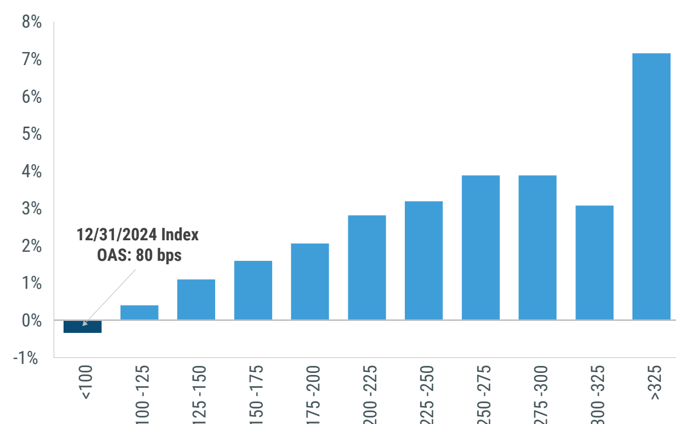


Our approach to fixed income investing is rooted in the observation that bond valuations can be much more volatile or persist at higher levels than underlying credit fundamentals would imply. Implicit in that observation is that both the constant assessment of credit risks and the prevailing pricing of credit risk are imperative to driving long-term returns. Our observations also dictate that there are times when the potential excess returns to credit instruments are quite weak. We sit at that time today.

Credit spreads – a metric that captures the amount of potential income that a credit investment offers vs. a risk-free bond – sit at historically low levels, not experienced since before the 2008 global financial crisis. For index-based investors, forward-looking return prospects are unattractive. The following chart shows how average spread compensation at today's levels has historically led to near-term underperformance of corporate index bonds against Treasuries.

IG corporate bond starting option-adjusted spread

And subsequent three-year annualized excess return (%)



Source: Bloomberg and BBH. Past performance does not guarantee future results.

What is an active credit manager to do in such an environment? Here, we lay out the implications this low credit spread environment has on the pillars of our investment process and portfolios and discuss how it aligns with income and safety priorities.

Implications of unattractive valuations

There are many reasons that a bond manager may hold credit instruments during environments when credit risk is priced unattractively. Bond managers may have performance objectives or incentives to maximize yields, or investors may embrace the notion that historical credit risks are unlikely to occur due to strong macroeconomic data. We believe that:

- Bond-level dynamics are critical to evaluate, necessitating a bottom-up approach.
- We do not need to know exactly what will cause credit spreads to reprice, but something will.

This environment is not new to us. We applied our process through multiple similar episodes of unattractive valuations for credit, including periods in late 2019 and late 2021. In those environments, we did not anticipate that a pandemic, a war between Russia and Ukraine, and a significant Federal Reserve tightening cycle, respectively, would cause credit to become more attractively valued. Rather, our bond-by-bond investment process naturally positioned us to more actively participate when an abundance of durable and attractively valued credits became available.

You might wonder what we do when faced with such expensive environments. Our fixed income team remains disciplined in our investment approach and lets the following elements of our process take center stage.

Continue to invest bottom-up

The virtues of bottom-up investing are evident in all environments and are difficult to understate. This tenet fosters a narrow focus on valuation and durability – sustainable long-term performance drivers for each credit.

Instead of trying to make top-down decisions based on generalizations about industries or the macroeconomy, we focus instead on whether each opportunity meets our valuation criteria and continues to offer the required level of durability. If the investment does, we will either buy it or continue to hold. If the investment does not, we will sell it and continue seeking opportunities. We believe the discipline of executing our process in that manner is the "secret sauce" of our process.

We spend our time *looking* for the next great value in all markets, but in today's valuation environment, we find less to act upon. This is a feature of our investment process, not a bug.

Reap the advantages of a broad opportunity set

At today's low level of spreads, our opportunity set has compressed, but we can still reliably find value in issues in many market segments that are either smaller, esoteric, or unrepresented in mainstream indices. The inclusion in our evaluation process of non-index credits across a variety of sectors is unique among fixed income managers, in our experience.

Looking beyond benchmark credits can uncover opportunities that still offer attractive valuations because of noneconomic reasons, such as investor preferences, rigid guidelines, liquidity concerns, or perhaps a misunderstanding of the actual underlying credit risks. These opportunities still offer strong durability features but lack the size, issuance frequency, number of assigned credit ratings, or structures that investors prefer. This willingness to look beyond benchmarks helps us identify durable credits at attractive yields, which continues to drive long-term, sustainable performance benefits.

When in doubt, don't just do something – stand there

Everything described so far may seem straightforward. In reality, it can be difficult to ignore the lure of some additional short-term return for otherwise durable credits when we deem them to have inadequate valuations. Our long-term focus requires embracing the uncertainty of when valuations will cheapen. We know that, on average, credit instruments will offer higher income over the long term, but we don't know what will cause valuations to change, nor when it will occur.

A strong valuation discipline provides a "north star" to navigate decisions in these environments. It allows us to be comfortable in saying "no" – a lot – when evaluating credits for potential purchase. This creates a culture where our analysts do not need to fear the consequences of inaction because they are investing according to a disciplined process, evaluating the broad opportunity set, and aligning credit investments with clients' long-term objectives in mind.

This same discipline applies to our continued focus on sound portfolio construction. During these expensive periods in credit markets, constant vigilance of portfolio exposures is maintained to limit any unintended risks or concentrations that can overwhelm potential benefits from our bottom-up credit selection. This includes:

- Limiting the risk of interest rate movement vs. the strategy's objectives
- Ensuring proper diversification
- Modeling risk factors
- Maintaining similar exposures across client portfolios

Portfolio impact

Applying our bottom-up, bond-by-bond investment process over the past few months resulted in measured changes to client portfolios due to both cash flows within the portfolios and our purchase, sale, and hold decisions. In general, portfolios have de-risked organically as bonds matured, we sold credits that reached our "sell" criteria, and attractive values diminished.

This can be observed in some of the following ways:

- The market weight of "reserves" or high-quality, liquid, non-credit investments such as U.S. Treasuries, futures, or cash has increased. These reserves are a source of available funds to purchase credits when appropriate valuations re-emerge.

- The market weight of credit investments decreased in a corresponding manner.

- The credit portion of portfolios has become less sensitive to future credit spread changes.

A strong valuation discipline provides a 'north star' to navigate decisions in these environments.

[O]ur investment process does not require precise predictions about the timing or magnitude of events for portfolios to perform well and align with client objectives.

Alignment with client objectives

Clients have many potential long-term objectives for their fixed income portfolios, including capital preservation, income generation, diversification of risks, liquidity, and downside protection. We are confident that a bottom-up investment process, executed properly, aligns with these objectives.

However, these long-term objectives can present conflicts when viewed through a short-term lens. For example, the desire to generate income can conflict with preservation of capital when credit valuations are expensive, as they are today. We believe that our portfolios are positioned to preserve capital through an episode when valuations are repriced to reflect the historical risks present in credit investments.

Conversely, when valuations become widely attractive, which tends to happen *after* a risk event, there comes a time to actively seize opportunities in the market and pursue objectives of income generation. Our steadfast focus on credit valuation and durability helps ensure that income potential is attained without sacrificing objectives of safety and preserving capital over the long term.

Today's credit markets are expensive. There is broad uncertainty about what risk event or interest rate movement will unfold next. Fortunately, our investment process does not require precise predictions about the timing or magnitude of events for portfolios to perform well and align with client objectives. As in past situations with similar credit conditions and sentiments, we do not know what future event(s) will rattle markets – nor do we need to know. We know something will occur to reset credit spreads, and it is best to be prepared to respond.

Conclusion

Our disciplined investment process of buying strong credits at appropriate valuations will not change. We believe our client portfolios are well positioned to navigate this period of narrow credit spreads. We are not avoiding risk; rather, we are approaching credit risk both cautiously and constructively. This process has worked in the past, and we believe at this point in the credit cycle that patience and discipline will be rewarded over the relatively small amount of extra income that can be attained.

If you are interested in learning more about our approach to credit investing, reach out to the BBH Fixed Income team or your BBH relationship team. ■

Thoughtful Gifting: How to Help Your Family Save for Healthcare

Brett Sovine J.D., LL.M
Principal

At BBH, we strive to help you design and implement an annual gifting plan that reinforces your financial values. If designed thoughtfully, a gifting program can encourage and reward work and productivity, financial discipline, and independence.

One way parents and grandparents can help young working family members start and boost their retirement savings is by combining tax-free annual exclusion gifting and income tax-free investment compounding in a Roth IRA early in the child's life, which can compound and provide a sizable retirement account over time. Here, we examine another option to help children later in life – in particular, those with a career and family and who may be concerned about the escalating costs of healthcare.

While not every graduate who takes a first job decides to participate in their employer's 401(k) or other retirement plan, almost all of them elect to participate in their employer's healthcare plan. Years ago, most U.S. employers covered most or all of the costs associated with offering medical insurance to employees and their families.

In recent decades, U.S. healthcare plans have changed significantly, with many employers implementing high-deductible healthcare plans (HDHP), which shift a much higher portion of a plan's annual cost to employees. Under an HDHP, employees still enjoy family medical coverage but must cover a significant portion of the initial costs of healthcare utilization annually. Essentially, HDHPs cover families against a catastrophic event but shift most of the routine annual costs of family healthcare to the employees.

In recognition of this change in the marketplace, Congress created federal health savings accounts (HSAs) to help families shoulder their increased share of out-of-pocket costs related to

HDHPs. An HSA allows employees to set aside pre-tax money (usually via payroll withholding) in an account that enjoys the same kind of income tax-free compounding experienced in a Roth IRA. Like many 401(k) plans, some employers will match a portion of employee contributions to their HSAs.

So, why wouldn't a young employee who works for a company that offers an HDHP set up and fully fund an HSA account each year? Youth. Young people tend to be healthy, and have many competing uses for salary dollars (such as transportation, work clothes, rent or a down payment, home furnishings, tools, media and mobile phone plans, car seats, daycare, entertainment, and so forth). Many young employees figure they will pay out-of-pocket costs as they come due, and if they don't get sick in a given year, the money could be better used elsewhere.

This is where a thoughtful gift from a parent or grandparent can help a young family member use the magic of tax-free compounding to build a healthcare nest egg for their family's future needs. In 2025, federal gift tax laws allow individuals to make annual gifts of cash to anyone up to $19,000 per year. This means parents or grandparents can gift an adult child up to $38,000 annually. Many of you do this already.

Consider the benefit of conditioning a portion of the gift on the recipient's full participation in funding an HSA. For 2025, an employee can contribute up to $4,300 for a self-only HSA and $8,550 for a family plan. For most plans, contributions must be made via an employee's payroll withholding, so a parent or grandparent cannot directly participate in an employer-sponsored HSA plan. However, they can sit down with their working child or grandchild and talk about the advantages of saving for retirement through 401(k) withholdings and of saving for future healthcare costs via HSA plan withholding.

The conversation might go something like the following:

Your father and I are proud of you, and we want to give you the maximum amount we can each year to help you and your spouse build financial security outside the trusts that have been set up for you. We can give you $38,000 next year but would like you to elect, during your upcoming open enrollment, to fully fund your employer-sponsored HSA in 2025.

The maximum amount you can contribute to an HSA is $8,550, so we are asking you to consider $8,550 of the $38,000 we give you a reimbursement of the salary you direct into your HSA at work in 2025. That leaves you a little less than $30,000 to pay for out-of-pocket costs you incur this year and to use however else you choose.

In other words, we would like you not to use the money you contribute to your HSA this year to pay whatever out-of-pocket healthcare costs you have to pay until your high-deductible health plan policy coverage kicks in. We are suggesting that you use our annual gift to begin building a healthcare savings account over your lifetime in an account that compounds income tax-free so that you and your family have a large account that can be used for medical surprises or your future healthcare costs when you are retired.

When combined with tax-deferred HSA compounding, care and coordination among generations' annual gifting can create a sizable healthcare nest egg for your children and their families.

Tax-deferred compounding helps illustrate this concept. Consider an HSA that is funded annually at $8,550 per year for 20 years beginning when the child/employee is 25 years old. At a 7% annual tax-free compounded return, the HSA account would compound to just over $365,000 after 20 years of annual contributions. Assuming no further contributions and no withdrawals from the account, the account would grow to just over $1,440,000 when the account owner attains retirement age of 65 years. Withdrawals can be taken from an HSA income tax-free prior to age 65 provided the withdrawn funds are used for eligible healthcare expenses (e.g., generally any medical cost that is deductible by individuals on their federal income taxes).

When combined with tax-deferred HSA compounding, care and coordination among generations' annual gifting can create a sizable healthcare nest egg for your children and their families. Assuming your child or grandchild's family does not need to use their HSA for healthcare costs, an acceptable healthcare expense includes premiums spent on healthcare or long-term care (LTC) insurance.

According to industry professionals, most individuals who take out a standalone LTC policy do so at or after 50 years old. Currently, a relatively healthy 50-year-old can secure an LTC policy that will cover five to seven years of nursing home or in-home nursing assistance for just over $125,000. Money contributed pre-tax to an employer-sponsored HSA can be used income tax-free to secure an LTC policy that provides in-home care for five to seven years income tax-free when needed. As illustrated, the HSA would have sufficient money to fully fund healthcare for your child and their spouse.

This is what we mean when we refer to thoughtful gifting: It educates, conveys values and priorities, and provides long-term security for the families that receive the gifted assets.

If your family has questions about leveraging their retirement or healthcare savings, contact your BBH wealth planner. ■

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PB-08168-2025-01-14 Expires 01/31/2027