

Perspective from
Franklin Equity Group

Allocate to optimism— Positioning for growth and innovation in 2025

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Key takeaways:

- The United States stands at the threshold of an innovation-led economic expansion
- AI-driven productivity gains, stable to accommodative monetary policy, and forward-looking deregulation set the stage for meaningful economic growth in 2025
- The Trump administration's lighter regulatory touch should foster a more dynamic business landscape, bolstering opportunities within technology, financial services, industrials, and energy

Overview

1. The US economy appears to be entering a **new, innovation-led business cycle** fueled by the rapid application of artificial intelligence (AI) across multiple sectors, health care innovation, energy infrastructure investment, and re-industrialization as manufacturers move onshore to avoid tariffs.
2. We anticipate a stable to accommodative interest rate environment, especially if inflation remains subdued and real gross domestic product (GDP) growth is supportive.
3. The incoming Trump administration's deregulatory efforts, combined with Silicon Valley's rising political influence, particularly in support of "little tech," are likely to foster a **more dynamic business landscape**. We see significant opportunities with a lighter regulatory touch for the financial services, crypto, technology, industrial, and energy industries.

While risks exist, we view them as manageable. To some, valuations may appear elevated, but we believe earnings estimates may be too low, given the potential acceleration in growth and innovation in coming quarters. In aggregate, our outlook is positive, and we encourage investors to allocate to optimism in 2025.

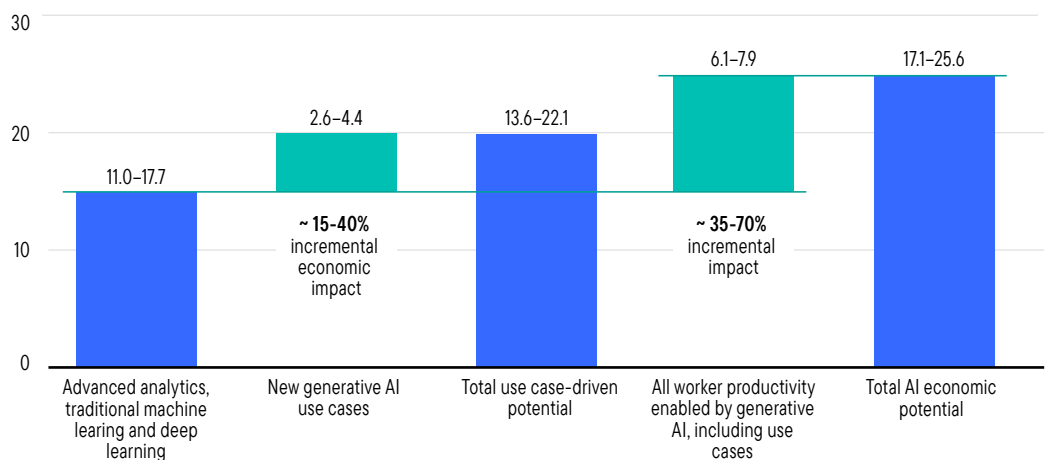
Dawn of a new business cycle

We believe the United States is on the cusp of an AI-driven productivity boom that could profoundly impact all sectors of the economy, and that many investors continue to underestimate the scale of this opportunity. Even modest gains in productivity, spread across the world's billion knowledge workers, would represent a massive shift in economic output and profitability. Additional value could be unlocked by new science and discovery opportunities beginning to emanate from AI reasoning models.

While early, key industries, including technology, health care, consumer staples, financial services, and energy, are already beginning to see tangible benefits from AI experimentation and adoption. We believe the United States is uniquely positioned to lead this transformation for three reasons:

1. The United States is home to the world's leading AI suppliers
2. The nation's cultural and business environment fosters technological experimentation and implementation
3. The Trump administration should reduce regulatory obstacles to AI development and deployment, extending our head start over global competitors

AI's potential impact on the global economy (US\$ trillions)



Source: McKinsey & Company. "The economic potential of generative AI." June 2023. There is no assurance that any estimate, forecast or projection will be realized.

In addition, we see promise in continued health care innovation, advanced energy production, and a "re-industrialization" of the US economy. Easing regulatory constraints, especially those affecting the financial services industry, could spur significant growth in the crypto opportunity.

The Trump administration aims to achieve what it calls "energy dominance" on a global scale. Energy infrastructure development holds significant strategic importance, aligning closely with the interests of Trump's tech and industrial-focused supporters. We expect the administration to prioritize expanding electricity and energy capacity across oil, coal, natural gas, nuclear and interstate transmission, as well as to update and expand electric generating capacity, enhance grid reliability and encourage energy storage technologies, such as batteries. This infrastructure focus supports national priorities, including economic growth and job creation, enhanced energy security and reduced dependence on foreign energy. It could bolster US competitiveness in emerging technologies, particularly AI, while simultaneously addressing rising electricity costs and grid stability issues.

Stable to accommodative monetary policy

The Fed is expected to maintain a growth-supportive stable to accommodative monetary stance through 2025. Market expectations suggest interest rates may settle into a 4%-4.25% range by mid-year, which should help sustain equity valuations, but with some potential volatility along the way. The Fed's careful calibration (supporting growth while balancing inflation risks) should underpin stable financial conditions in 2025, providing a favorable backdrop for equities. While investors should remain vigilant, especially given that any Fed action can create volatility, the current Fed commentary suggests a moderating, but still accommodative approach to policy changes. Such an environment should create certainty and support innovation-led investment and growth across sectors.

Deregulation and the influence of innovators, disruptors, and operators

A major catalyst for growth and optimism in 2025 is the incoming administration's push toward deregulation and government efficiency. Drawing inspiration from Reagan-era efforts, current policy direction aims to reduce bureaucratic red tape, rationalize government spending, and streamline federal agencies. The result should be a business-friendly environment that stimulates competition, lowers compliance costs and encourages innovation in finance, transportation, energy and technology.

This movement is reinforced by a new generation of influential policymakers: Silicon Valley entrepreneurs, disruptors and other business leaders. While many of these new players are public policy neophytes, their focus on growth, rapid decision-making, and technological advancement echoes past deregulatory cycles that unleashed periods of robust economic performance.

Key objectives include dismantling outdated dealmaking regulations, accelerating capital formation, and ensuring "little tech" companies can thrive under transparent and minimal regulatory oversight. The emphasis on national security, energy independence, and productivity aligns with a broader vision to maintain US global leadership in innovation. Investments in areas like space exploration, AI-driven manufacturing, robotics, and logistics automation all stand to benefit.

Trump's pro-innovation policies do carry tension and contradictions. They could come with substantial fiscal costs, which could spur inflation and interest rate challenges. They could also result in significant changes to current policies, such as the Chips Act and the Inflation Reduction Act. In addition, innovators like Elon Musk simultaneously advocate for rapid technological advancement, while also voicing concern over the dangers of unchecked AI development. Investors should note this inherent unpredictability, as shifts in regulation or sentiment could alter investment dynamics.

Key risks

Despite our optimism, several risks warrant close attention.

On the geopolitical front, tariff policies could disrupt supply chains and push inflation higher, potentially pressuring interest rates and equity valuations. Federal tax cuts must translate into real economic growth, or heightened fiscal deficits may undermine credit and equity markets. Narrow majorities in Congress and pushback from left-leaning US states and others could slow or dilute reforms, reducing the scope of deregulation and fiscal restructuring. While Trump has promised resolution, the Russia/Ukraine conflict remains highly volatile, with tensions moving higher in recent weeks. In addition, economic pressures on China are high, and could be exacerbated by additional US tariffs and technology restrictions.

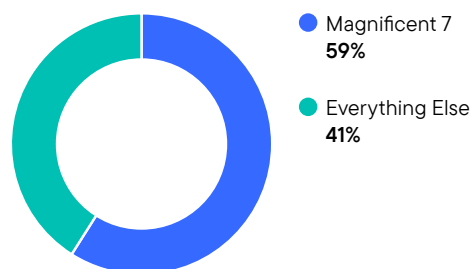
While there are numerous AI application green shoots across software development, IT and customer support, marketing, document summarization, and media creation, broad AI adoption will take time. For the past two years, we have been solidly in the “build and experimentation” phase of AI, which has benefited chip suppliers, cloud computing vendors and other infrastructure providers. AI governance, predictability, and explainability remain open challenges in this emerging era of probabilistic computing. We see some challenges to continued training scaling, although we believe these will be offset by inference time scaling and other algorithmic improvements.

While we are optimistic about sustained growth and innovation in the health care sector, particularly regarding demographics, the adoption of GLP-1s, ongoing biotechnology and genomic advancements, and the application of AI, there is considerable policy uncertainty associated with Trump's health care appointments. We anticipate public health agencies will experience substantial changes in leadership and policy focus.

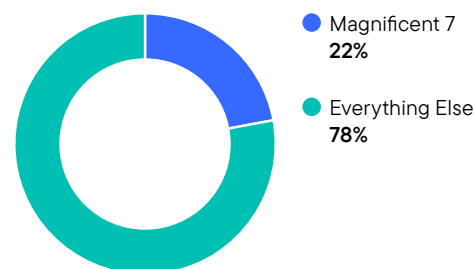
Valuations don't screen cheap. As of late December, the market-cap weighted S&P 500 appeared expensive at +25x forward earnings, but this metric was dominated by the largest companies in the index.¹ Many of these businesses have offered resiliency, quality and earnings growth through their leadership in structural opportunities such as AI. But while we continue to favor many of these companies (and believe that their earnings potential may be undervalued as AI adoption accelerates and the business cycle builds momentum), we also see relative value down the market cap spectrum. To this point, the equal-weighted S&P 500 trades at a relatively more attractive +21x earnings.² During the first half of 2024, 100% of the S&P 500's positive returns came from less than 45 companies.³ During the second half of the year, that number was nearly 100.⁴ Markets appear to be broadening out.

Markets appear to be broadening

% Contribution to index return, 1H 2024



% Contribution to index return 2H, 2024



Source: FactSet. As of November 30, 2024. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** “Magnificent Seven” refers to Alphabet, Amazon, Apple, Microsoft, Meta, Nvidia, and Tesla.

Conclusion

As we enter 2025, the United States stands at the threshold of an innovation-led expansion. The interplay of AI-driven productivity gains, accommodative monetary policy, and forward-looking deregulation sets the stage for meaningful economic growth. Though uncertainties persist, the opportunities—especially among smaller, emerging companies and sectors poised to benefit from a lighter regulatory touch—are compelling.

By maintaining a positive investment outlook and focusing on innovators leading the charge, investors can position themselves to capitalize on a year that promises significant advances in technology, productivity, and long-term prosperity.

Endnotes

1. Source: Standard & Poor's. As of December 12, 2024.
2. Source: Standard & Poor's. As of December 12, 2024.
3. Source: FactSet as of November 30, 2024.
4. Source: FactSet as of November 30, 2024.

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All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal.

Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks.

Investment strategies which incorporate the identification **of thematic investment opportunities**, and their performance, may be negatively impacted if the investment manager does not correctly identify such opportunities or if the theme develops in an unexpected manner. Focusing investments in **information technology (IT)** and **technology-related industries**, carries much greater risks of adverse developments and price movements in such industries than a strategy that invests in a wider variety of industries.

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