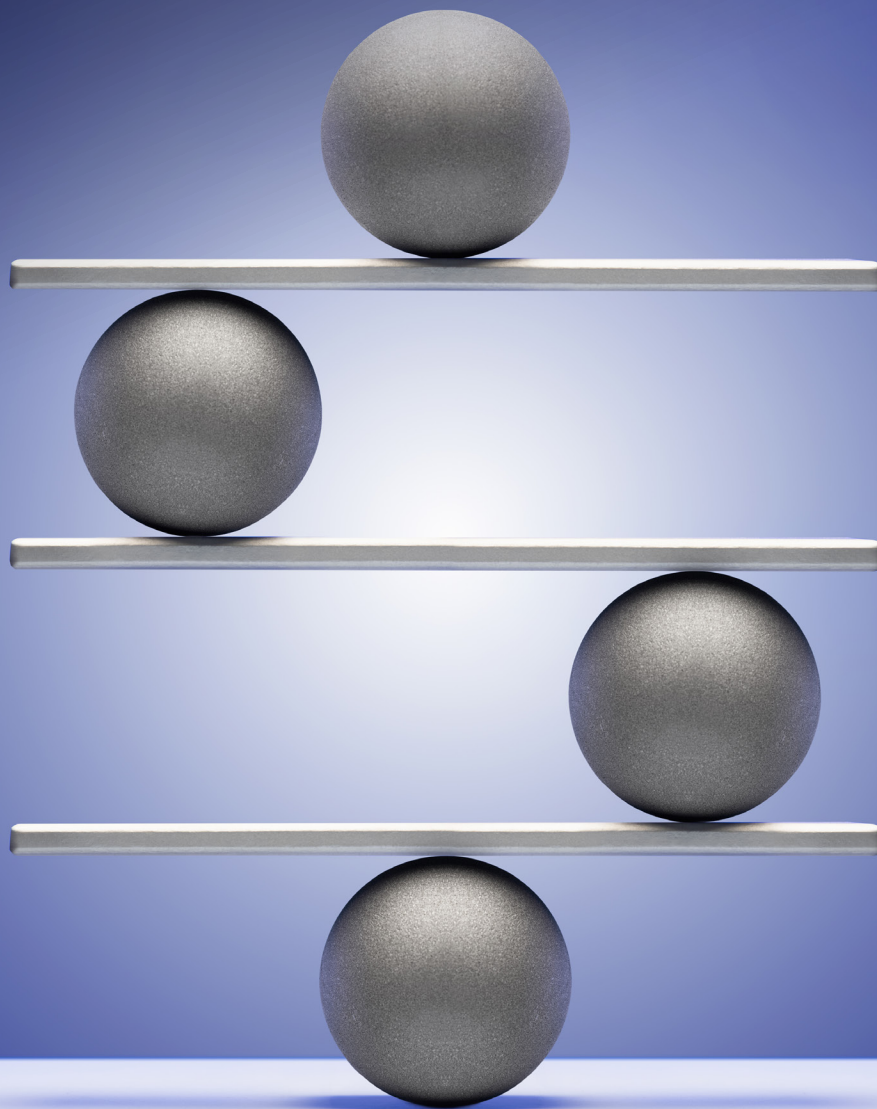


2025 Annual Outlook

The Great Moderation: Riding a Wave of Economic Stability

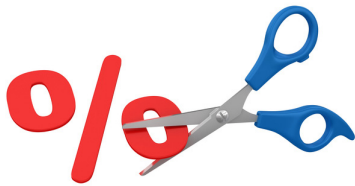


Cetera® Investment Management LLC

Throughout history, major market events often earn memorable names. In the 1930s, we saw the Great Depression, and more recently, we had the Great Financial Crisis. While it's usually the negative news events that get these attention-grabbing titles, if we were going to coin a name for what we expect in 2025, it would be the Great Moderation.

As we approach the five-year anniversary of the pandemic's onset in the United States, the economy is still moderating toward pre-pandemic levels. The pandemic and its aftermath disrupted supply chains, labor markets, inflation, and economic growth, leading to significant fluctuations across these indicators. These effects have rippled through stock and bond markets, shaping economic conditions for years.

At-A-Glance



The Fed went from foe to friend in 2024, starting its long-awaited interest-rate cutting cycle with a surprise 0.5% interest rate cut in September. Rate cuts came later than investors were anticipating when the year started, as inflation ran hotter for longer.

Economic growth cooled from the high levels posted at the end of 2023. The labor market has begun to weaken, but economic growth remains steady, avoiding a recession in 2024.



It was a contentious election year, and many were fearful of volatility around the election.

We went to great lengths throughout the year putting this in context. Past election cycles showed that investors should focus on their own investment goals and not let election fears cloud their judgment.

The broad aggregate bond market is up around 2% year-to-date as yields have fluctuated after the election due to higher growth and inflation expectations.



Stocks have had a good year with large cap indexes up around 25% as of this writing.

Large-cap stocks have outperformed small caps, with much of the returns concentrated on large companies that make up a huge portion of many indexes.

Stimulus funds are still circulating through the economy, though their impact has waned. Economic growth is deaccelerating, as is inflation, and the labor market is beginning to soften from historically strong levels. The Federal Reserve has now entered a rate-cutting cycle, moving interest rates closer to a neutral rate – a level we’ve rarely seen in the past 15 years. After the Great Financial Crisis and the pandemic, interest rates were slashed to zero, whereas recent Fed policy has been highly restrictive to combat inflation. Now, all these forementioned factors, particularly the Fed Funds rate, are becoming less extreme.

This theme of moderation extends beyond economic data and the Fed. In equities, we are seeing extreme concentrations within indexes, where a handful of stocks dominate and drive much of the index performance. These stocks have driven valuations upward, with their prices exceeding earnings by substantial multiples. In 2025, we may see a moderation in equities as other stocks gain ground, particularly smaller companies with more attractive valuations, which could benefit in a lower interest rate environment. What has performed well in the past may not perform as well in the future. Likewise, stocks that have lagged for years may finally start to outperform.

In bonds, we anticipate more moderation. The Treasury yield curve remained inverted for over two years – the longest in history – with shorter-term bonds yielding more than longer-term bonds. This inversion has ended, and we expect the curve to steepen as the Fed cuts rates, likely lowering short-term yields. While some bond market volatility is expected over the next year, returns may align with yields, plus a modest boost from price appreciation. As interest rates on savings accounts and money markets decline, bonds may be attractive to investors seeking better returns.

Diversification is prudent, and your Cetera financial professional can help you navigate uncertainty while keeping you focused on your personal goals and objectives.

For a quicker look into what we are thinking and what is happening in the economy and markets, check out our 2025 Annual Outlook Summary.



Economy

2025: A Pivotal Year

2025 could prove to be a pivotal year for both the economy and markets. To understand why, we need to revisit how we got here. The pandemic and its aftermath significantly disrupted economy and market conditions for years. The pandemic-driven recession began in March 2020 and lasted only two months. During spring of that period, real GDP growth plummeted at an annualized rate of 28% before rebounding over 35% the following quarter, then gradually settling to below 3%. Government stimulus provided crucial support for the economy and markets, ultimately injecting over \$800 billion dollars into the economy through three rounds of stimulus. Additionally, the Inflation Reduction Act of 2022 and CHIPS and Science Act included an additional \$400 billion and \$50 billion, respectively, in federal funding to be deployed over the next decade.

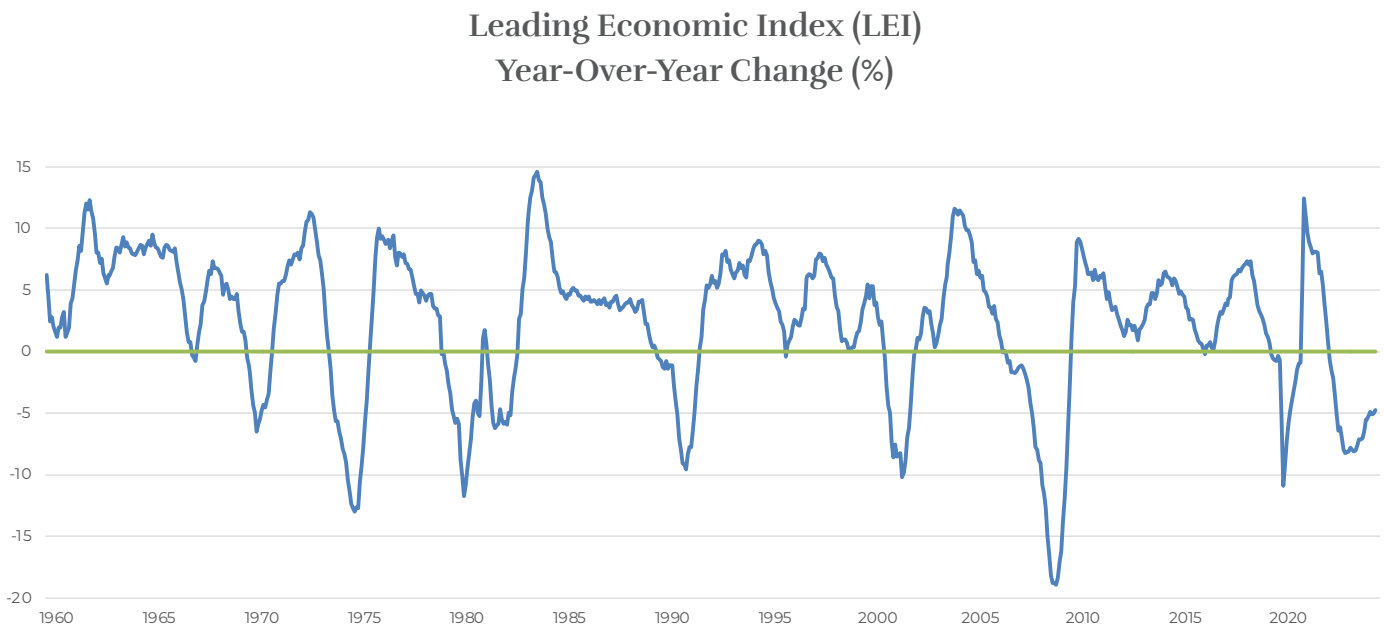
While this stimulus helped propel the economy and continues to have an impact, it also came at a cost. Inflation initially surged due to pandemic-related supply disruptions, but the influx of funds into the economy further accelerated price increases. The Consumer Price Index (CPI) peaked at nearly 9% in June 2022 on an annualized basis. Since then, inflation has been moderating at a steady pace, moving closer to the Fed's target of 2%.



Is a Recession Possible...or Probable?

This brings us to 2025. With GDP growth and inflation easing, the question arises: are we heading into a recession? Looking at traditional recession indicators, one could make a strong argument. Over the past 75 years, when the unemployment rate bottoms out and begins to rise, a recession has often followed. Similarly, when the yield curve inverts – where the 10-year Treasury yield is lower than the 2-year Treasury yield – and starts to revert, a recession is typically seen. The same can be said when the Leading Economic Index (LEI) dips sharply negative and begins to recover, as shown in **Figure 1**.

Figure 1: Leading Economic Index



Source: Cetera Investment Management, FactSet, The Conference Board. Data as of 9/30/2024.

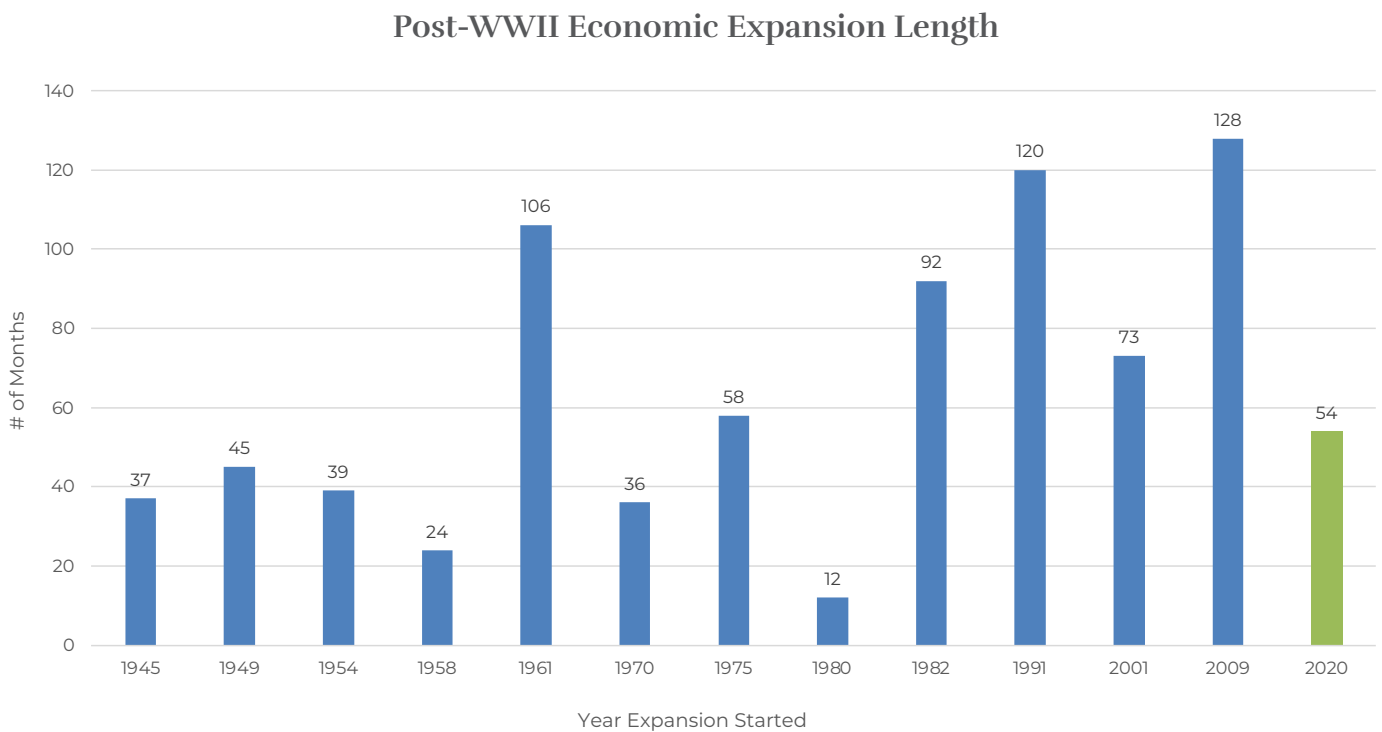
Could this time be different though? The past five years have been anything but normal, so it's possible that this time may be different. Key signs of a potential recession will likely emerge from the labor market, which we will be watching very closely in 2025. If consumers have stable jobs and feel secure in their employment, they are more likely to continue spending, which is crucial for this consumer-driven economy. Additionally, the Leading Economic Index is more sensitive to the manufacturing sector than the services sector.

Another key consumer group, the baby boomers, may continue to drive spending even without holding jobs. As the wealthiest generation, baby boomers have amassed approximately \$80 trillion in net wealth. Additionally, they stand to inherit an estimated \$20 trillion from the Silent Generation. Baby boomers may be more inclined to spend money than previous generations, potentially providing a demographic tailwind to consumer spending.

Reasons to be Optimistic: The Great Moderation

It is easy to get caught up in recession indicators, but we must acknowledge that the past five years have been marked by significant distortions. It's possible that we're simply experiencing the Great Moderation, where the economy is normalizing after all these disruptions. After all, by many traditional recession indicators, we should have already entered a recession – yet we're now 54 months into the current economic expansion. Historically, the average expansion in the post-WWII era has lasted 64 months, but the previous four expansions averaged 103 months, or roughly 8.5 years. This suggests we could be in a mid-cycle expansion, as illustrated in **Figure 2**. Federal Reserve Board members and Federal Reserve Bank presidents project real GDP growth of around 2% next year, a forecast aligned with many economists. While growth may not be stellar, it is expected to remain positive.

Figure 2: Mid Cycle Expansion?

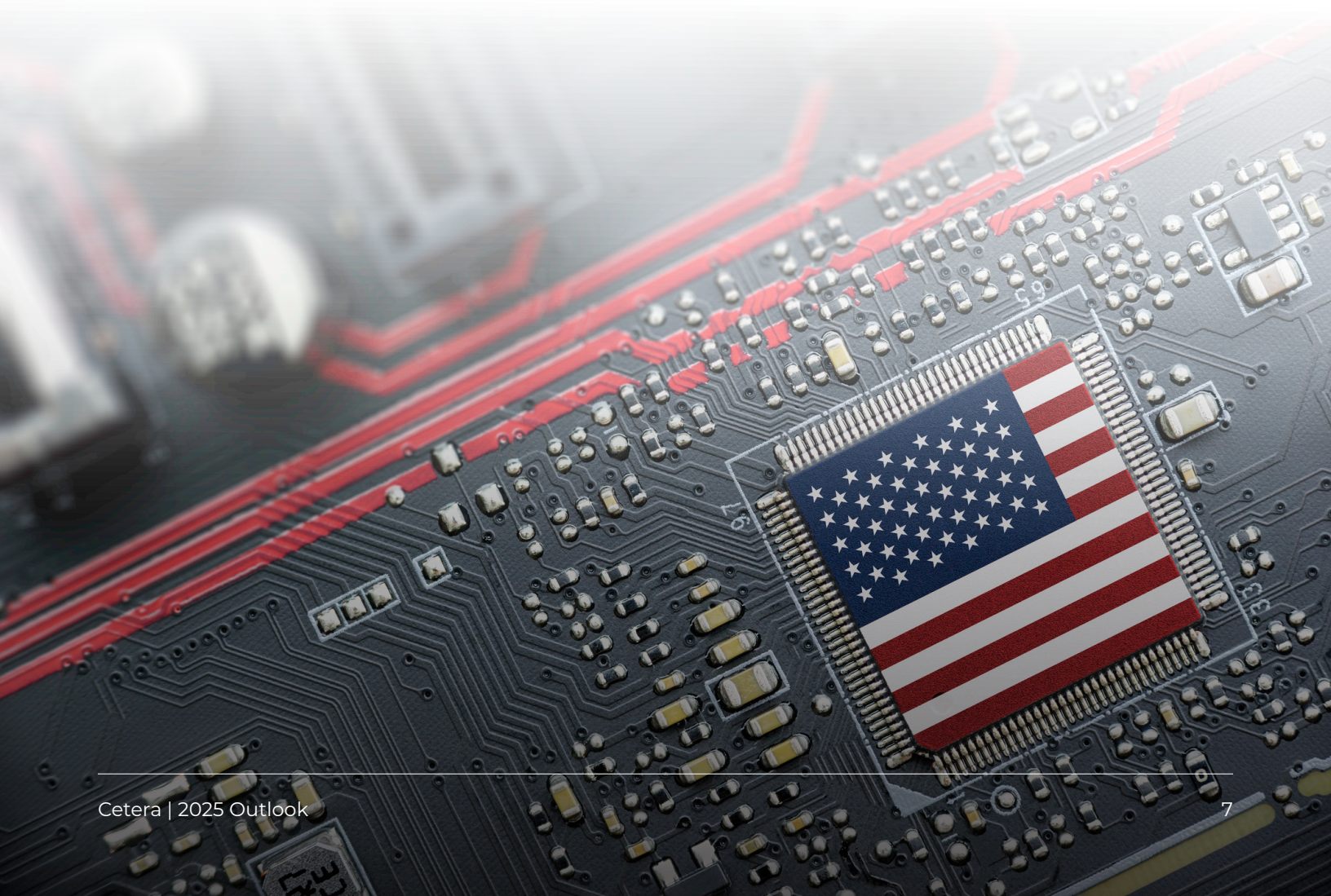


Source: Cetera Investment Management, National Bureau of Economic Research (NBER). Data as of 10/31/2024.

We highlighted some reasons to be cautious, but let's now consider the bull case. If the Great Moderation were to materialize, we would see moderated economic growth and inflation, with the Fed gradually adjusting the Fed Funds rate back toward neutral, aligning more closely with the inflation rate. This scenario would essentially represent the soft-landing we've discussed in our previous market outlooks.

The Fed has shifted from foe to friend, with the interest rate-cutting cycle now underway and short-term interest rates beginning to fall. While we may be in a mid-cycle economic expansion, interest rate-sensitive sectors are still struggling and could benefit from lower rates. These sectors include housing, manufacturing, autos, and consumer durable goods. The housing sector, once weighted down by excess supply after the Great Financial Crisis, now faces low inventories. If mortgage rates decline, housing activity could rebound, potentially becoming a major growth driver for the economy, similar to what we saw in the early 2000s. Homebuyers typically purchase big-ticket items like furniture and appliances, which could further stimulate economic growth. This may be a longer-term trend, but it's something investors should keep in mind, as markets tend to look ahead. Additionally, millennials, the largest generation in the U.S., are now at the age for peak household formation, which will likely increase housing demand.

Government deficit spending is expected to persist well into the future, with unspent stimulus funds still in circulation. This ongoing fiscal support should continue to act as a tailwind for years to come. The CHIPS and Science Act has already sparked a boom in semiconductor manufacturing facilities across the United States, contributing to a broader long-term trend of onshoring. Thanks to our abundant natural resources, energy prices in the U.S. can remain competitive, and advancements in artificial intelligence and robotics may enable us to produce goods more cost-effectively than relying on foreign labor. Additionally, lower shipping costs would further enhance this advantage. This shift could also drive higher productivity – more output per labor hour – potentially leading to higher wages, with early signs of productivity gains already emerging.



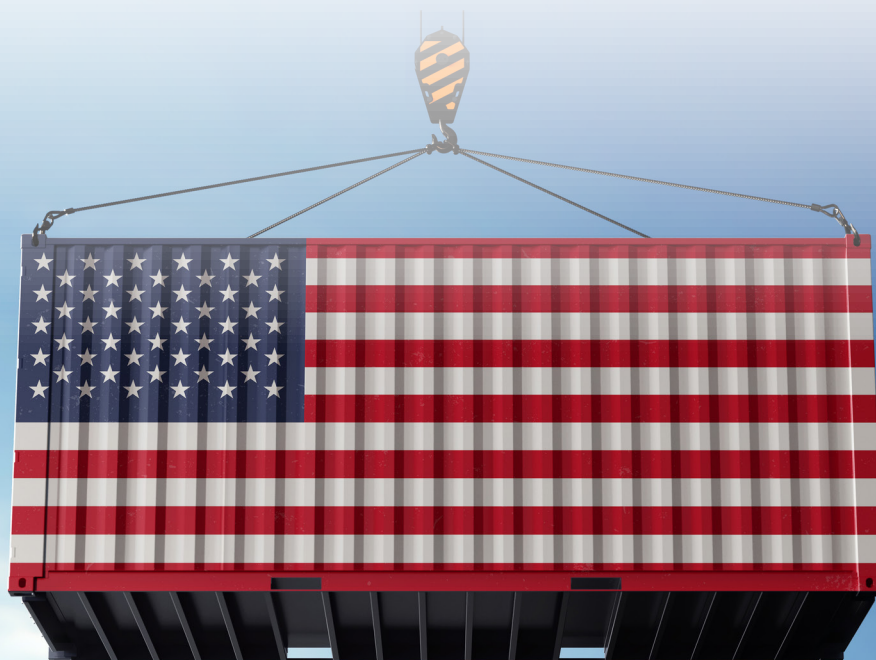
Did We “Whip” Inflation?

Reading these bullish scenarios, you might be wondering if some could lead to rising inflation – and you wouldn't be wrong. Is the Fed stimulating an already resilient economy by cutting interest rates? Could inflation start to creep up again, as we saw in the 1970s? While it's unlikely we'll see “WIN” (Whip Inflation Now) pins making a comeback, inflation isn't entirely gone. While inflation may be easing, it's far from dead.



The Fed currently appears restrictive, with the Fed Funds rate well above the inflation rate, giving the Fed room to cut rates further. However, we wouldn't be surprised to see inflation tick up again in 2025, like what we saw in the first quarter of 2024. While the overall trend of moderating inflation may still hold, data does not move in a smooth path. If inflation does rise, it could cause investors to question the moderating trend, potentially triggering market volatility. Although the Fed has shifted from foe to friend, it may not be as good of a friend as one might hope for. The data-dependent Fed may be forced to pause interest rate cuts, leaving investor expectations unfulfilled. This was our thesis even before the election.

While both presidential candidates favored increasing tariffs, Trump is likely to implement them more broadly. Regardless, we can expect more tariffs on China and other key exporters, which could lead to an uptick in goods inflation, an area that has been near zero recently. This creates a dilemma for the Fed: if they remain restrictive for too long, it could induce an economic slowdown, or even trigger a recession. The impact of these tariffs may take time to materialize, with a potential lag in their effect on the economy and inflation. This uncertainty complicates matters further for the Fed, which is working to control inflation but may struggle to gauge its future trajectory.



Looking Abroad

Geopolitical risks are high right now, but if there are resolutions to these conflicts, it could bode well for Europe. While we often view geopolitics as a potential risk, there are possible upside surprises if these wars come to an end. This could include cheaper energy prices in Europe and overall, less uncertainty about the escalation of these wars.

Capital Economics, an economic research firm, projects that Euro-zone real GDP will grow to 0.8% in 2025, marking a slight improvement from 2024. Germany, Europe's largest economy, is currently in a recession and is likely to see its second consecutive year of negative real GDP growth, though both years are expected to be only slightly negative. However, Capital Economics forecasts a rebound for Germany with real GDP growth expected to reach 0.5% in 2025. This figure could improve further if the war in Ukraine comes to an end.

Japan may also experience a GDP contraction in 2024 but is expected to rebound with near 1% growth in 2025. Meanwhile, the Chinese government continues to inject stimulus into their economy as they work through a real estate slump caused by excess supply. Additionally, China is grappling with what some are calling a two-speed economy, where exports are booming while domestic consumption struggles. Any tariffs imposed on Chinese goods by the United States may come at a challenging time for China, which could make them more willing to negotiate and concede on key issues. Capital Economics expects China's real GDP growth to moderate to 4.5% in 2025 from 5% in 2024. While this may seem high for developed countries, it could feel like a recession in China. The good news for China is that copper prices are stabilizing, which may signal economic stabilization. As the largest importer of copper, China's demand for this metal is often seen as a gauge of its economic health – higher demand for copper typically indicates a strong economy.

Other emerging markets, such as India and Mexico, are likely to continue benefiting from the United States' efforts to diversify away from Chinese goods. The pandemic exposed the United States' reliance on China, and naturally, it is wise to diversify that reliance. Real GDP growth in India and Mexico is projected to be 5.5% and 8.50%, respectively. These numbers are lower than in 2024 but still represent healthy growth. Moderation is not limited to the United States, as the entire world experienced distorted economic data due to the pandemic and the stimulus that followed.



Summing it Up

The global economy is moderating back to pre-pandemic levels. The economic distortions caused by social distancing measures and supply side disruptions, followed by the enormous stimulus packages, are fading. Central banks were forced to raise interest rates to combat the inflation that followed. Now, central banks are largely cutting rates as inflation and economic growth subside. We expect these trends to continue, but because data does not move in a straight line, we anticipate occasional upticks in inflation and growth, which could cause the Fed to pause its interest rate cuts. Investors have seen the Fed go from foe to friend, but it might not be as good a friend as many think.

Overall, we are cautiously optimistic about the global economy and the Fed's ability to engineer a soft landing. While some recession indicators are raising a red flag, these same indicators could be telling us that a recession has already been averted. We will continue to watch the labor market closely in 2025, as it will provide the clearest clues about where the economy is headed.



Equity Markets

Moderation In Stocks – Return to the Mean

The Great Moderation could also be applied to stocks. Right now, stock indexes are highly concentrated in a handful of large tech-oriented companies. The top 10 stocks in the S&P 500 comprise more than 30% of the index because these companies are so large, and the index is weighted by company size. The largest companies also contributed to much of the return of the index in recent years. Diversifying away from these top 10 stocks has caused portfolios to lag the highly concentrated indexes in recent years, but maybe 2025 will be the year of moderation. Maybe market breadth will widen, and returns will be relatively stronger for a broader range of stocks and sectors. This could happen two ways: the other stocks could catch up or the larger stocks could retreat.

Currently, the S&P 500 is on pace to notch its second consecutive year with a return over 20%. These returns are roughly double the annualized average over the past 30 years, which is nearly 11%. To be fair, the last couple of years have not been normal, and there have been some ups and downs. The S&P 500 was down nearly 20% in 2022 and has since rebounded. If we smooth out the recent past and take the average annualized return over the past five-years, as of the day of this writing, the average annualized return is nearly 15%. This is great news for equity investors, but it should also bring caution. Future returns would have to be lower to achieve the historical average of the S&P 500. This is called “reversion to the mean”. Many investment firms, including Cetera Investment Management, have lowered future long-term stock return estimates to account for high valuations and moderating returns in the future.



Lofty Expectations

U.S. large cap stocks have been partially driven higher by prospects of future earnings growth and the possibility of increased productivity made possible by robotics and artificial intelligence. This has driven valuation metrics much higher. Stock prices relative to their future expected earnings are well above long-term averages and climbing. While not at dot-com bubble levels experienced from 1995 to 2000, they are still lofty. For these valuation metrics to improve, either earnings growth must exceed expectations or stock prices must fall. Valuations can remain elevated for long periods of time, so predicting when one of these things will happen will be difficult. The bull case is that as productivity improves, earnings will catch up. Keep in mind that the earnings we are looking at are already expected future earnings with the prospects of productivity enhancements included in them. The bear case is that the stock prices will fall as earnings expectations are not met. **Figure 3** illustrates the relatively high forward P/Es.

Figure 3: High Valuations



Source: Cetera Investment Management, FactSet, Standard & Poor's. Investors Cannot Invest Directly in Indexes. Data as of 10/31/2024.

So, while we expect moderating economic growth and are somewhat optimistic about the U.S. economy, U.S. large cap stocks may be overpriced. Corporate earnings are already expected to increase at double-digit growth rates in 2025. These growth rates are already baked into stock prices as the stock market is forward looking.

Don't Forget About Diversification – The Lost Decade

The good news here is that we are only cautious about U.S. large cap stocks and particularly the mega-cap stocks in that index, such as the Magnificent 7. Outside of large cap stocks, valuations look better. U.S. small and mid-cap, international developed, and emerging market valuations are all much closer to their long-term averages. This isn't the first time large cap and especially large cap growth stock valuations have been very elevated. During the dotcom bubble these valuations were extended for years before the "lost decade" followed, when the S&P 500 (large cap index) posted a negative 10-year return from 2000-2009. We are not saying there will be another lost decade, but it is a powerful illustration of how future returns can be impacted by high valuations.

Don't forget the power of diversification, as the last decade was not lost for investors that invested in diversified asset allocation models. Investors can still own large cap, but be mindful about concentration risk and diversify with other asset classes. Keep in mind, what has done well in the past may be the reason it may not do well in the future. Likewise, why something has underperformed in the past may be why it could do well in the future.

Case in point - international equities. Many U.S. investors have shunned international stocks for more than a decade because they have underperformed U.S. stocks. Much of the reason for this has been the strength of the U.S. dollar. When the dollar strengthens, it hurts U.S. investors investing abroad because it makes the earnings in other currencies worth less in U.S. dollar terms. The dollar has been strengthening since 2011. Currency cycles can be long, but more recently the dollar seems to have peaked in the fall of 2022, and we are starting to see returns in international stocks improve. International indexes also have less technology exposure than the S&P 500, a sector that has seen valuations soar. Keep in mind these international companies are not small French bakeries and German pubs, they are multi-national companies that you are likely familiar with ranging from oil companies to pharmaceuticals and automobile manufacturers. You likely even own a lot of these companies' products.

While trying to time when long-term trends emerge, we are cautious about the potential weakening of the dollar during the second Trump presidency, which could lead to higher bond yields and support overall U.S. dollar strength. While the dollar appears to be a headwind for international investors, diversification in international stocks may still be prudent for the other reasons we discussed.

Summing it up

We would not be surprised to see a market correction, defined as a stock market decline of 10% or more, sometime in 2025. However, corrections happen nearly every year, so this is not a bold prediction. Volatility and declines are expected in investing. The good news is that we don't expect a market correction to be long-lasting. Investors have significant cash in savings and money market accounts. When the Fed lowers interest rates, these assets will earn less, and naturally, some of this money will flow into the stock and bond markets as investors look for better entry points. We always stress diversification, but this year may be even more important following the strong stock returns we've seen in the past couple of years. Stocks, sectors, and countries that have performed well recently may not do as well in the future. Small cap stocks, which have better valuations relative to their average, have been slightly negative over the past three years. They also stand to benefit from lower interest rates. Building a diversified portfolio is very important to mitigating potential volatility.

Fixed Income

Moderating Interest Rates

Bond markets look to continue the theme of the Great Moderation, as the Fed is expected to continue cutting interest rates in 2025. This will have a direct impact on shorter-term bond yields and should provide support for lower bond yields across the curve. The impact of the rate cuts will diminish the longer the maturity of the bond in question. With that in mind, the yield curve should continue to steepen as short-term bond yields fall faster than long-term bond yields, which are more tied to long-term growth and inflation expectations. This would be welcomed by banks which pay interest on short-term assets like savings accounts and certificates of deposits and make money on longer-term assets like mortgage loans.



Expect Volatility in Bond Markets

Bond yields moved higher after the presidential election due to prospects of higher inflation caused by more tariffs and potentially higher economic growth from reduced regulation and corporate taxes. While these long-term themes are valid, many other factors influence bond yields and economic growth, so the equations are not that simple. We do expect to see volatility in bonds, centered around news of tariffs, tax legislation, the Fed, and deregulation, potentially causing fluctuations in bond prices and yields in 2025. Overall, we expect bond yields to moderate along with inflation, economic growth, and the Fed Funds rate. Falling bond yields mean higher bond prices, so we expect bond returns in 2025 to be the current yield plus some price appreciation. If that thesis holds true, we could see the aggregate bond market return around 5% or more next year.



Tight High-Yield Spreads

Below-investment-grade bonds, also known as high-yield bonds, are less sensitive to interest rate movements and more sensitive to economic and equity factors. If recession fears rise or an equity market correction occurs, high-yield bonds are expected to fall, as investors anticipate more defaults and downgrades. Currently, high-yield bond investors are not demanding much extra spread over risk-free Treasury bonds for this added risk. This is good news for stock market investors because it suggests the bond market does not anticipate a recession anytime soon. However, these expectations can change quickly.



Low Municipal Bond Ratios

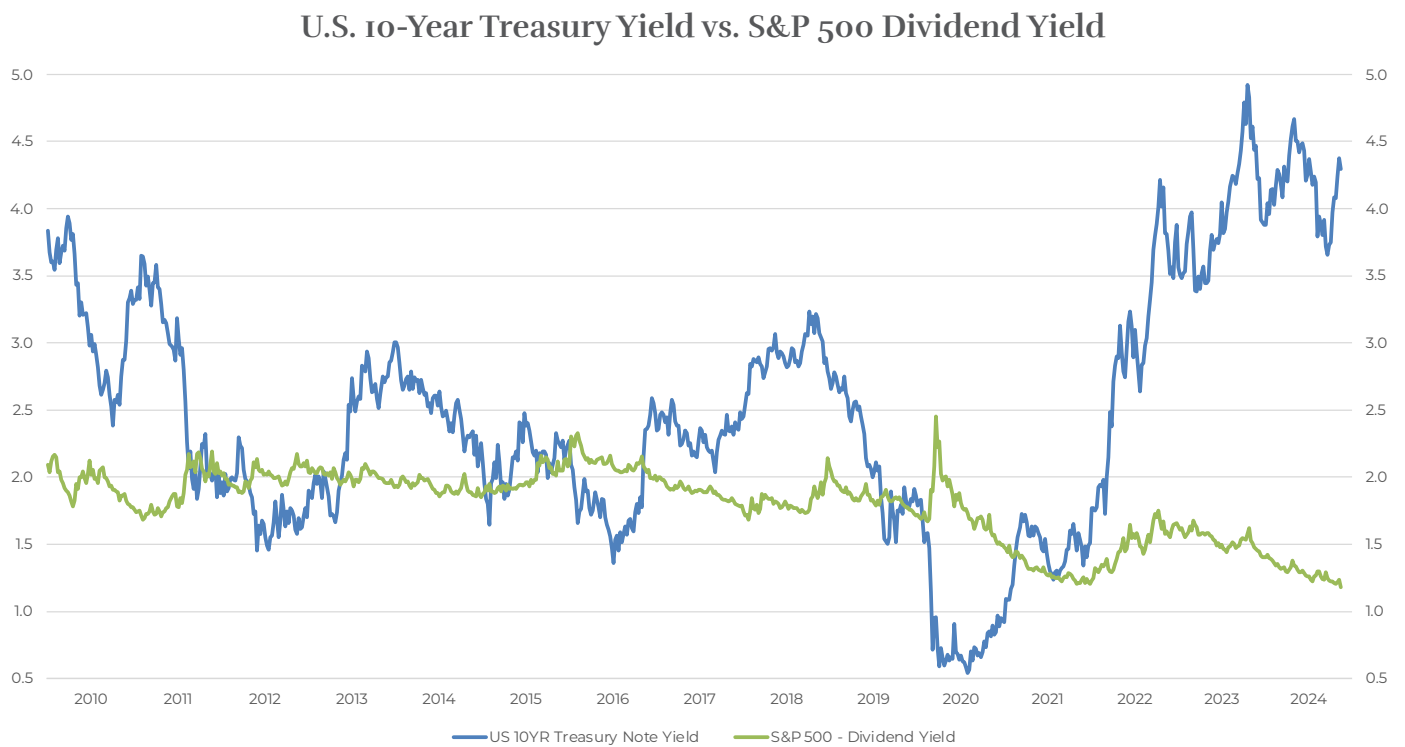
Municipal bonds, like high-yield bonds, are less attractive from a spread perspective. One of the common metrics used to evaluate the municipal bond market is the ratio between the Treasury yields and AAA-rated municipal bond yields. On rare occasions, the AAA-rated municipal bonds can exceed those of Treasury bonds with the same maturity. These are called “crossover” opportunities because non-taxable investors may find municipal bonds attractive at that point. However, this is not the case now.

Currently, these ratios are mostly in the 60% to 70% range for intermediate maturities, improving at longer maturities but still relatively low. However, municipal bonds can still be attractive to taxable investors when considering the tax benefits, and these ratios are improving compared to recent years.

Summing it up

We expect returns in bond markets to be similar to their current yields, with a little extra for price appreciation, as yields will likely moderate from current levels. We do expect volatility in the bond markets due to noise around tariffs and the Fed. We also expect equity volatility, given high valuations after a period of strong stock market performance. Bonds could be a good diversifier to reduce volatility risk from equities. As the Fed cuts short-term interest rates, bank savings accounts and money market funds will pay less, which could drive assets back into bonds, which offer higher yields. If you recall, when interest rates were near zero, some bond investors turned to equity markets in search of yield. This was not ideal, but for many, there was no alternative. Today, bond yields are much higher than stock dividend yields, as seen in **Figure 4**. Investors seeking yield will likely transition from money market to bonds. This could provide a tailwind for bonds over the next couple years. With both economic growth and inflation moderating, this will also support bonds.

Figure 4: There is an Alternative



Source: Cetera Investment Management, FactSet, U.S. Treasury Department, Standard & Poor's. Data as of 11/8/2024

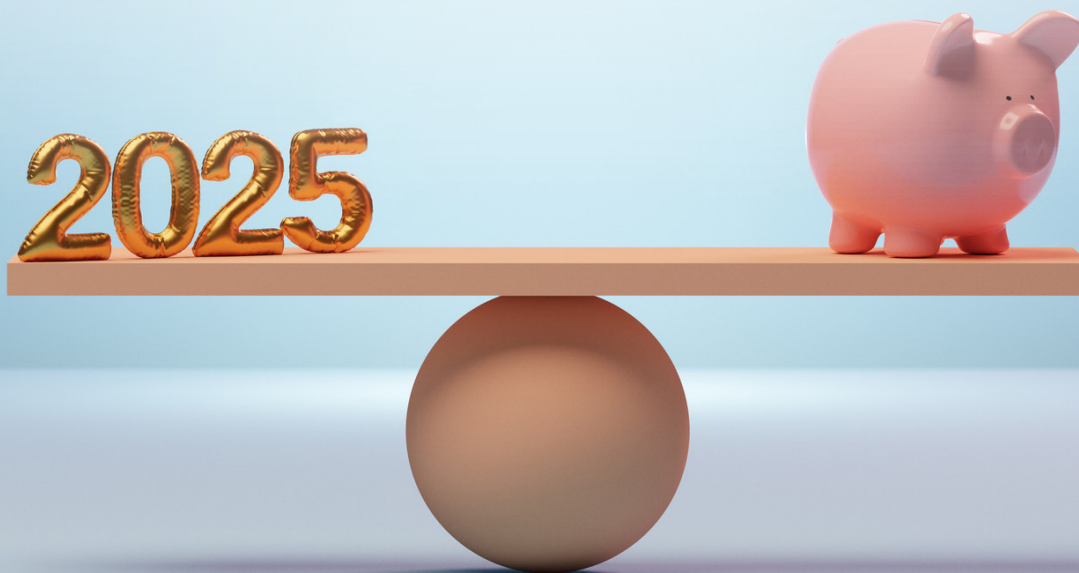
The Bottom Line

Next year could end up being known as the Great Moderation, with inflation, interest rates, labor economic growth, stock returns and bond returns all moderating. As always, such predictions involve numerous factors and carry inherent risks. Rising volatility is also present along with the chance of a stock market correction – although this is not a bold prediction, as corrections typically happen most years.

We anticipate inflation may remain stubborn at times and may not follow a straightforward path downward, raising questions about whether the Fed will lower rates as much as expected. Fed rate-cut expectations for 2025 have already been falling since shortly after September's surprise 0.5% interest rate cut, but these expectations will continue to shift as new economic data emerges. Increased equity volatility, coupled with lower rates, should be supportive for the bond market, as investors look to mitigate equity fluctuations and shift assets from money markets and savings accounts into bonds for potentially higher returns.

While we discussed high concentrations and valuations in the stock market, these are not necessarily true of the entire stock market. There are more attractive valuations outside of U.S. large cap growth stocks. 2025 could be the year of diversification and expanding market breadth. What has performed well in the past may not perform as well in the future, creating opportunities for asset classes and stocks that have lagged in recent years, such as smaller company stocks.

Diversification is prudent, and your Cetera financial professional can help you navigate any uncertainty to keep you focused on your personal goals and objectives.



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A diversified portfolio does not assure a profit or protect against loss in a declining market.

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg US Aggregate Bond Index is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. Eligible bonds must have at least one year until final maturity, but the index holdings have a fluctuating average life or around 8.25 years. This total return index is unhedged and rebalances monthly.

The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. Securities must have a below investment grade rating (average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings). Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of \$100 million.