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# Checking in on the Markets

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## 2025 Themes….So Far

As expected, market volatility has increased in 2025 with Trump 2.0. We all know Trump is unorthodox and is always willing to shake up the status quo. There is always a level of uncertainty at any point in time, but it seems like that uncertainty is very high for investors with all the questions about how far Trump will go with tariffs and the potential consequences of those actions. I'm of the opinion that there is more bark than bite with these bold statements. Yes, there will be tariffs, but not nearly as high as Trump has threatened nor as wide across so many countries and goods that have been mentioned. Trump considers the stock market performance as an important part of his scorecard, and I believe the majority of these tariff threats are more negotiation tactics than anything.

Besides tariffs, the other big topic of discussion so far this year has been international developed markets outperforming US equities. I believe a big contributing factor in that outperformance is the wide dispersion of equity valuations. Over the last 10 years, European equities have traded at approximately a 23% average discount relative to the United States. That discount started the year at a much deeper 36%. So far into 2025, investors have been buyers of that valuation gap, with it narrowing it by five percentage points to 31% year-to-date. With US equities trading at frothy valuations, it leaves little room for disappointment, especially for the very rich valuations in Technology. The news of Deepseek has put pressure on those Mega Tech valuations. As of last Friday, Technology was one of two sectors with negative YTD performance. International equities are trading at more attractive valuations with the Euro Stoxx 50's forward PE at 14. With stocks trading at those valuations, a little good news can go a long way and provide some pop in those stock returns. European stocks have some tailwinds gathering behind them including an easing ECB, a potential de-escalation of the Russia-Ukraine conflict, which could open it back up to Russian energy, and positive earnings growth in the 4th quarter after 6 negative quarters.

| Market Performance | As of 2/21/25 |
|---|---|
| **Sector** | **YTD** |
| Communication Services | 4.92 |
| Consumer Discretionary | (3.35) |
| Consumer Staples | 6.50 |
| Energy | 5.96 |
| Financials | 5.10 |
| Health Care | 6.53 |
| Industrials | 2.32 |
| Information Technology | (0.19) |
| Materials | 4.73 |
| Real Estate | 3.85 |
| Utilities | 6.06 |

**Market Performance data provided by S&P sector indices returns*

I do believe this trend will be short-lived, and the US will reassume a leadership role in 2025. I believe US equity fundamentals are still stronger with higher earnings projections and profit margins. Consumer spending also remains much stronger in the US than in developed international countries. However, I still advocate for some international developed equity exposure. As the world backtracks from globalization and more protectionist policies are implemented by countries, we will most likely see better diversification benefits in portfolios with international equities allocations. Over the past 100 days, we have seen the correlation between the S&P 500 and the MSCI EAFE drop from 0.83 to 0.54. I believe this trend will continue due to deglobalization. Within Europe, I like the Industrial sector as countries will most likely ramp up defense spending due to Trump's threats to leave NATO. A recent research report calculates that it would cost around 250 billion euros ($261.71 billion) annually to raise European defense spending to 3.5% of gross domestic product from around 2% now.

## Economic Outlook

We have seen US inflation concerns reignite recently and I believe those concerns are slightly overblown. While inflation will remain stubborn and it will take time to bring it down to the Fed's 2% target, the disinflationary trend is slowly moving in the right direction. In the past two years, the imbalance in the labor markets was applying upward pressure on inflation with higher wage growth, but the labor market is now balanced and is no longer a source of inflation. The AI revolution will bring productivity gains across many sectors, which will further boost the disinflationary trend as will Trump's deregulation plans, which should reduce company costs. I'm concerned that the Fed will fall behind the curve if policy uncertainty stops them from multiple rate cuts this year. The Fed has always described itself as being data dependent, so it should not stall rate cuts due to Trump's tendencies to use tariff threats as a method to negotiate in public. It seems like there are different views on this subject within the Fed as Federal Reserve governor Christopher Waller said the central bank should cut interest rates further if inflation makes more progress back toward target, even if Trump administration policies are adding economic uncertainty. Fed governor Michelle Bowman seems to have a different view when she recently said in a speech that patience will give the Fed a stronger understanding of the policy landscape. While the unemployment rate is near historic lows, continuing claims are elevated due to low hiring across companies. The labor market remains healthy, but it is slowly deteriorating, and the Fed needs to be proactive to avoid any unnecessary economic downturns.

The Fed always tracks consumer inflation expectations, and they certainly noticed the recent University of Michigan's consumer sentiment reading. The final reading confirmed the massive jump in consumers' inflation expectations this month. Consumers' year-ahead inflation expectations shot up to 4.3% from 3.3%, reaching their highest level since November 2023 and leaving expectations significantly above the pre-pandemic range. One point of caution is that the University of Michigan survey switched to online surveys last year, which has increased the variance of reported inflation expectations. The details show the rise in inflation expectations reflects an increase in the number of people reporting very high expected inflation. These surveys tend to be very political too, so I don't think the Fed should be too concerned about this reading. While the relationship between consumer confidence and consumer spending has weakened in recent years, I do think that the more aggressive ramp up in tariffs means consumers will reel in their spending sooner than anticipated, but not by much. Healthy household balance sheets will continue to support spending by high- and middle-income consumers.

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We saw a disappointing retail sales report from last month, but that report was affected by the California wildfires and the cold winter across the country. At an aggregate level, the US consumer remains healthy, but it is becoming more bifurcated. According to Moody's Analytics, the top 10% of US earners (households with earnings above $250K) represented nearly 50% of consumer spending. 30 years ago, that consumer segment represented approximately 36% of spending. The US consumer net worth is up nearly 50% since 2019, and most of that wealth accumulation was due to the stock market and real estate appreciation, which the lower end consumer typically does not have as much exposure to. This growing bifurcation is another reason why I believe multiple rate cuts by the Fed are warranted this year.

## Investment Outlook

Overall, I remain optimistic this year. I believe this "economic scare" is a bit overblown and corporate earnings had a solid 4th quarter. I would advocate for some slight tilts towards certain areas of the market.

- I still believe investors should slightly overweight US equities as these companies have a superior fundamental outlook, but as mentioned above, I still advocate for some international equity exposure as the valuation discount of international vs the US is near record lows and the correlation between these asset classes is dropping.
- Financial stocks are off to a great start in 2025 with 84% of Financials beating their earnings estimates in the 4th quarter and earnings growing nearly 52% on a year-over year basis. I believe there is more upside in this sector as M&A activity should pick up in 2025 as interest rates drop and Financial's profit margins should increase due to deregulation.
- I continue to really like Healthcare due to the high potential of weight loss drugs and the increasing need for healthcare services with aging demographics of developed markets. Some analysts have estimated that the weight-loss drug industry will be worth $80 - $140 billion annually by 2030 with an estimated 40 million Americans likely using these drugs. During earnings season, pharmaceutical companies eased some investor fears of slowing demand as their forecasts for revenue growth in 2025 ranged from 20 – 32%. Healthcare is projected to have the second highest sector earnings growth in 2025 (20.5%).
- Trump's victory can bring more support to mid/small cap stocks as his proposed policies should benefit domestic companies. Typically, 90% of mid/small cap revenues are domestic based (as opposed to 60% for US large cap stocks), so this asset class may benefit if Trump reengages in similar trade wars from his first term. Small cap stocks are very interest rate sensitive, so their rally has stalled as the market has backed out some Fed rate cuts and the 10-year treasury yield shot up from 4.17% in December to 4.8% in mid-January. However, I do believe there will be multiple rate cuts this year, which should help reignite that rally and the 10-year Treasury has recently been slowly dropping. Both Mid and Small cap valuations are more attractive than their Large cap peers, and both asset classes earnings projections for 2025 are higher than Large caps.
- I also like Utilities. Utilities has long been considered a defensive strategy in portfolios, but due to the enormous power demand from the AI movement, Utilities are now considered part of the offensive playbook for AI investing. After a decade of anemic growth in power demand of roughly 1% to 2% annually, the AI revolution is propelling power demand growth estimates for utilities up to 6% to 8% annually over the next 10 years. This growth in power demand has the potential for improved earnings growth and durable multiple expansion for utilities.