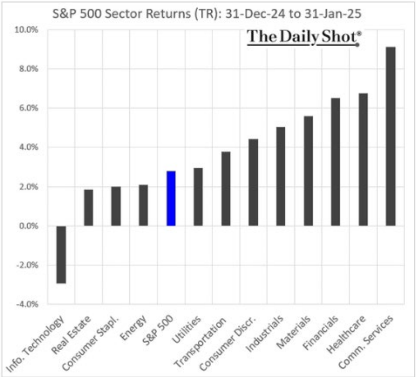
EQUITY MARKET UPDATE

As of 1/31/25 | Volume 14, Issue 1 | FFTAM.com

Stocks finished a bumpy month broadly higher despite escalating trade disputes, an uncertain path for interest rates, and a tech scare from the Deep Seek AI model in China. The positive return masked the high levels of volatility taking place among individual names. It was not unusual to see trading sessions that involved major names swinging in 10%+ increments. This speaks to the sensitivity surrounding high valuation, hopes for lower interest rates, and uncertainty with taxes and tariffs.

The S&P 500 gained 2.78%. The rally was broad-based with every sector increasing in value, except technology. The results would have been much worse without large gains in Meta Platforms, Amazon, and Alphabet. These three stocks started the year with strong returns that offset large drops in NVIDIA, Apple, Microsoft, and Broadcom. As mentioned earlier, volatility has been very high. To put things in perspective, the index gained 2.78%, but the average stock rallied 3.61%, while the median stock increased 3.36%. This would lead you to believe that strategies with underweight tech positions would have been widely successful in January. However, the range in returns between the best and worst-performing stocks was unusually high, meaning last month was truly a stock picker's market.



The Dow Jones Industrial Average gained 4.78%. Less tech exposure, along with strong rallies from Goldman Sachs, United Health, and JP Morgan Chase, positively impacted results.

The NASDAQ increased 1.66% in January. The index was the best performer for most of the month; however, many AI-related names took a nosedive after the release of the Deep Seek AI model from China sparked fears that the US was losing the race in artificial intelligence. Initially, some called the release a Sputnik moment for our generation, but as the days have passed, it has become apparent that American tech companies still have a significant lead in AI despite some nuanced improvements introduced by Deep Seek.

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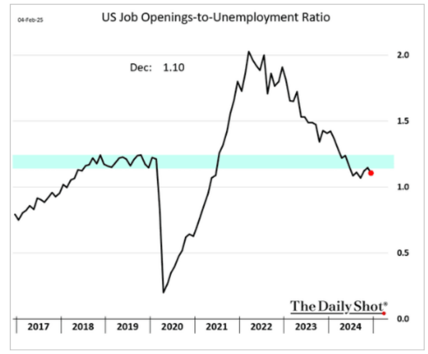
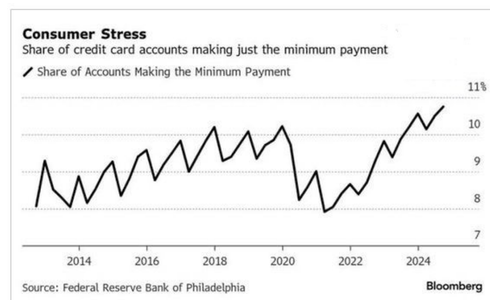
Mid and small-sized stocks were the winners last month among broad-based indexes. The S&P 400 Mid Cap (+3.85%) and S&P 600 Small Cap (+2.91%) indexes rose on improved earnings from banks, along with less exposure to potential tariffs. We also saw a rotation into lower valuation names, which aided these indexes given their steep discount versus large-cap peers.



The US economy remains on solid footing; however, segments that are interest rate sensitive, like housing, are relatively weak. Consumer spending is strong, but many metrics show stress among lower-income households. Labor, which has been the bright spot for the past two years, appears to be returning to more normalized conditions. January payrolls showed that another 143,000 jobs were created. Unemployment ticked down to 4.0%. Wages were up 4.1% from one year ago, an amount that continues to exceed both the Fed's expectations and the pay raises seen pre-COVID. The labor market is tight, but competition to recruit and retain employees has obviously waned. The JOLTS report showed that there are 7.6 million jobs open but unfilled. There are currently 1.1 job openings for every unemployed person. This is below the levels seen pre-COVID, and it indicates that getting a new job is becoming harder for people on unemployment.

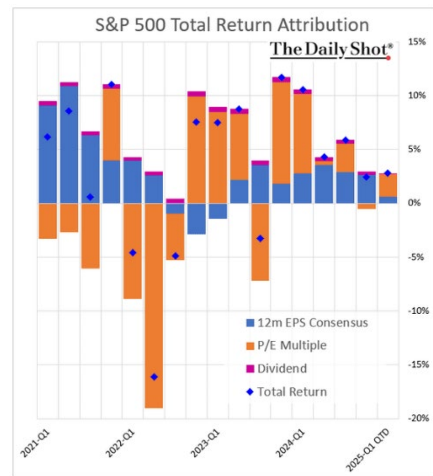
Consumer inflation continues to be stubborn, with prices increasing 2.9% from one year ago. Core inflation that removes food and energy ticked lower to 3.2%. PCE data, the Fed's preferred measure of inflation, showed total prices climbing 2.6%, while prices ex-food and energy rose 2.8%. These statistics are much better than the high-water marks seen in 2022, and they are within reach of the Fed's 2% target. However, the pace of improvement has slowed dramatically the past few months. This is fueling a large debate among investors on how much room the Fed has left to lower interest rates.



Despite wage growth and relatively low unemployment, clouds are forming over select segments of the consumer population. Personal income grew 0.4% in January. Total spending rose 0.7%, while retail sales climbed 0.4%. The savings rate remains well below pre-COVID levels. Consumers have increasingly funded their expenditures with the use of debt. Credit card balances are at record amounts, and debt delinquency has climbed from one year ago in both credit cards and auto loans, especially among people with lower credit scores. Until Mr. Trump provides greater details on his economic policies, monthly job reports and weekly unemployment claims are vital pieces of information to watch to gauge the strength of the consumer.

Business investment appears to be thawing despite the higher interest rates. The ISM Manufacturing PMI Index was 50.9. This index has fallen in 25 of the last 27 months, but this was the third straight month of improvement. Employment data (50.3) showed manufacturers hired workers for the first time since September 2023. Manufacturing jobs have fallen in 20 of the last 24 months, something that historically happens only during recessionary periods. On the bright side, new orders (55.1) expanded for the third straight month, signaling future demand for products is growing, although some wonder if this number could be skewed by businesses ordering products and components before the proposed tariffs from President Trump take effect. Services have been the engine powering the economy, although data has softened the past few months. The ISM Service PMI Index fell to 52.8 from 54.1 the previous month. Service employment (52.3) signals labor needs have normalized. New orders (an indicator of future demand) dropped to 51.3. Prices paid for services (60.4) were hot and continue to be the epicenter of inflation.

Collectively, the data shows the Fed is winning the battle with inflation, although as stated above, the pace of improvement, especially in services, has waned. The FOMC held interest rates steady at 4.25% to 4.50%. Dot plots indicate the central bank believes rates will be between 3.50% and 3.75% by the end of 2025, implying rates will only be cut twice in 2025. The Fed appears to be entering a new wait-and-see phase given stubborn inflation and uncertainty surrounding President Trump's threatened use of tariffs against major trading partners. During the press conference, Chairman Jerome Powell said: "We would need to see real progress on inflation or unexpected weakness in the labor market before considering further rate reductions."

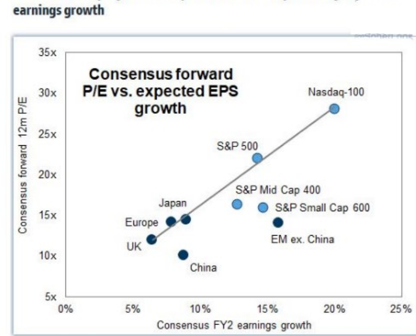


The S&P 500 currently trades at 22.2x forward earnings estimates. This is up from 19.3x one year ago, and it is above both the 5-year (19.8x) and 10-year (18.2x) averages despite the higher interest rate environment. The equity risk premium that compensates investors for the excess risks associated with stocks compared to bonds remains historically thin.

We are currently in the thick of earnings season. So far, 46% of companies have reported results. Year-over-profits are up 13.2%, the highest mark since the 4th quarter of 2021. This is better than the consensus forecast of 11.9%. Analysts remain very bullish about the future. They are forecasting 2025 earnings growth of 14.3%, a slight downward adjustment from last month's 14.8% view given weaker than expected forward guidance by numerous companies.

With the market trading at higher valuations than the past decade, it is fair to say plenty of good news has been priced into stocks. The S&P 500's return the past two years has exceeded profit growth, resulting in back-to-back years of PE multiple expansion. This tells us investors are fully convinced that inflation and interest rates will be coming down while overall demand for goods and services will remain intact (i.e., soft landing or "Goldilocks" scenario). This is not impossible, but it sets a very high hurdle for both the Fed and the market. It also makes stocks highly sensitive to tariff announcements from President-elect Trump and possible tax negotiations within Congress later this year.

Exhibit 5: US equity valuation premium can be explained by expected earnings growth



Source: FactSet, Goldman Sachs Global Investment Research

It is also important to keep in mind that the market's projected valuation is heavily skewed by the premiums being assigned to the big tech companies at the top of the index. If you equal weight the names inside the S&P 500, the forward PE ratio drops from 22.2x to 17.7x, a much more reasonable valuation but still not exactly cheap. The struggle for investors is that the big tech companies are experiencing the largest growth rates as they roll out artificial intelligence; meanwhile, economically sensitive sectors like energy and financials trade at deep discounts but need the economy to remain strong for an extended period to justify a prolonged re-rating in their shares.

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At a time in which the risk-to-reward outlook appears challenging, we are focusing on quality companies with lower valuations, strong balance sheets, and growing dividend streams to enhance returns. For several months, we have been incorporating a barbell strategy to capture the discounts being applied to both interest rate-sensitive (banks and REITs) and defensive (utilities and healthcare) areas. Our conviction remains high in these areas, and we have begun to see select value in parts of technology after many companies experienced sharp drawdowns after the release of the Deep Seek model from China.

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