February 2025

MONTHLY MARKET INSIGHTS

Key takeaways:

- The Federal Reserve ("Fed") held off on interest rate cuts at the January Federal Open Market Committee ("FOMC") meeting. Elevated inflation levels, a healthy labor market, and heightened tariff policy uncertainty will likely encourage the Fed to stay on hold until its June meeting.
- The release of DeepSeek's high-quality, cost-efficient model creates further tailwinds for the Artificial Intelligence ("AI") trend. However, investors are beginning to reevaluate the infrastructure spend required to develop AI initiatives.
- President Donald Trump implemented a vast array of policies in his first few weeks in office. Tariff policy raises geopolitical uncertainty and presents a major risk to global equity and currency markets.

US stocks were broadly able to post solid gains in January despite emerging challenges to the secular AI trend and a surge in geopolitical uncertainty. The S&P 500 returned 2.70% in January, while the tech-heavy NASDAQ returned a slightly lower 2.22%.[1] The first month of 2025 reversed many 2024 market trends as value outperformed growth, while the Technology sector was the only GICS sector to post a negative return. Market breadth increased as the S&P 500 Equal Weight index outperformed the Magnificent 7, returning 4.20% and 2.46%, respectively. Chinese equities had a challenging month with the CSI 300, a market-cap weighted index of Chinese A shares, down -3.83% in January, although still well above 2024 lows.[2] Europe's Stoxx 600 index was the standout global index posting its best month in two years. Strong earnings boosted investor confidence, widening the appeal of the region's stocks.

On the whole, US economic data remains healthy, creating a solid backdrop that should backstop risk assets during periods of heightened volatility. The US economy grew 2.3% in the fourth quarter of 2024, somewhat below expectations.[3] Nonetheless, consumer spending rose 4.2% on an annualized basis, well above expectations and reflective of continued US consumer strength.[4] The strength of the US consumer was a major driver of economic growth over the past two years, and consumer spending growth in Q4 2024 gives us confidence in our forecast of above-trend economic activity in 2025, barring the realization of the looming risks. On the other hand, robust consumption was partially offset by the inventories component that created a 90-basis-point drag on overall growth as companies sold much more product out of inventory this quarter.[5] We view last quarter's weakness in business investment as a one-time effect that should dissipate as corporations reset their operations. On January 10, the jobs report indicated the US added 256,000 jobs in December, while the unemployment rate ticked down to 4.1%.[6] US stocks plunged after the report, reaching their lowest levels of the month, while Treasury yields rose, as the market lowered its expectations for Fed rate cuts this year. More recent jobs data reflect a healthy labor market that we anticipate will remain firm in 2025 and support consumer spending throughout the year.

1. Bloomberg.
2. Id.
3. U.S. Bureau of Economic Analysis
4. Id.
5. Id.
6. U.S. Bureau of Labor Statistics

Inflation remains at elevated levels that should encourage a pause in the Fed rate-cutting cycle, at least for the first few months of 2025. The December Personal Consumption Expenditures report, the Fed's preferred inflation gauge, showed headline inflation growing 2.6% year-over-year while the core reading, excluding food and energy, increased 2.8% on an annualized basis.[7] Inflation continues to trend downwards from the historically high levels seen in 2022 but remains well above the Fed's 2% target. The Fed should maintain rates at current levels for the next few meetings, especially considering shelter inflation and tariff uncertainty bias inflation to the upside. Unsurprisingly, the FOMC did not cut rates at its January meeting after 100 basis points of cuts in 2024 signaling a hawkish pivot from the Fed. However, Chairman Powell struck a slightly dovish tone in his press conference by indicating that policy was still meaningfully restrictive, but did imply that the FOMC is hesitant to move rates until it knows more about the Trump administration's policy changes. In light of recent escalations to tariff policy and strong labor data, we anticipate the Fed will hold off on further rate cuts until the June meeting.

Meanwhile, US companies are amid earnings season, and so far, corporate earnings have broadly come in better than expected. At the end of the month, earnings growth for the fourth quarter is expected to be at 11.5% while revenue growth is expected to come in at 4.6%.[8] Communications and Financials have been the two strongest sectors, with earnings growth of 30.3% and 28.8%, respectively. Financials have been led by the big banks whose earnings have benefited from a resurgence in capital market activity and optimism towards de-regulation post-election. Robust consumer spending, cost-cutting efforts, and a blowout report from bellwether Netflix have supported profits in the Communications sectors. On the other hand, Technology earnings have proven more mixed, especially among the Magnificent 7, as Tesla and Microsoft failed to meet expectations. At the same time, Apple posted a slight beat while Meta healthily surpassed expectations and returned 17.71% through the month. The remaining Magnificent 7 earnings reports will be closely observed by market participants in hopes of clues regarding the effects of recent AI developments.

On January 27, Chinese AI company, DeepSeek, announced the launch of its R1 model, whose quality compares to industry-leading US AI models, yet was allegedly created for a fraction of the cost. DeepSeek claimed to have built its model in two months while only spending $6 million on computing power from less-advanced Nvidia H800 chips. In comparison, major US tech companies have spent billions of dollars on Nvidia's premium H100 chips to train their AI models, with pledges to spend further billions in the coming years. The quality and cost efficiency of DeepSeek's model challenges the perceived notion of US dominance in the AI race. The model's cost and efficiency have also catalyzed a complete reevaluation of AI infrastructure stocks among investors.

Nvidia was the most impacted stock by DeepSeek's announcement, dropping 17% that trading day and eliminating nearly $600 billion in market value.[9] DeepSeek's ability to train high-performance AI models with significantly less computing power could reduce the demand for Nvidia's high-end GPUs used in AI development. While increased efficiencies could dampen demand in the short-term, we believe the surging adoption of AI resulting from increased cost efficiencies will still require massive investment. Further, the development of lower compute models can also broaden the opportunity set for other AI stocks that have lagged Nvidia in recent years. The newfound cost efficiencies should prove beneficial to companies building AI software applications and agents through reduced costs and expanding margins. Further, we expect big tech companies to leverage distribution networks to provide AI solutions to a growing addressable market while benefitting from capital expenditure savings. M&A activity is likely to increase across the AI space as big tech seeks to increase their AI offerings through acquisition.

While DeepSeek's announcement appears momentous for AI, there remain a few key questions and spillover effects regarding the R1 model's development. First, allegations have arisen that DeepSeek used a distillation process to train its model off OpenAI's, violating OpenAI's terms and conditions. Microsoft defines distillation as "a technique designed to transfer knowledge of a large pre-trained model into a smaller model, enabling the student model to achieve comparable performance to the teacher model."[10] While these allegations have sparked con-

7. Bloomberg

8. Grabinski, Ryan. "Daily Macro Brief Feb. 3 2025." Strategas, 3 Feb. 2025, www.strategasrp.com/Document/Index?strResearchProductID=cEcO%2fHMaVeKRPUPbGyXZLQ%3d%3d.

9. Huang, Raffaele, et al. "Everyone's Rattled by the Rise of DeepSeek—Except Nvidia, Which Enabled It." Wall Street Journal, 2 Feb. 2025, www.wsj.com/tech/ai/nvidia-jensen-huang-ai-china-deepseek-51217c40?mod=Searchresults_pos2&page=1.

10. Yadav, Vishal, and Nikhil Panday. "Distillation: Turning Smaller Models into High-Performance, Cost-Effective Solutions: Microsoft Community Hub." TECHCOMMUNITY.MICROSOFT.COM, 6 Dec. 2024, techcommunity.microsoft.com/blog/aiplatformblog/distillation-turning-smaller-models-into-high-performance-cost-effective-solutio/4355029.

troversy recently, we believe DeepSeek's success will ultimately push frontier developers towards an open-source strategy currently being used by Meta. Recent comments by OpenAI founder Sam Altman appear to support this notion. Second, given US chip export restrictions, DeepSeek's actual compute efficiency remains nebulous. For example, illicit imports of higher-quality Nvidia chips into China may have been used, implying DeepSeek's compute efficiency may be overstated. Regardless, significant efficiencies have been achieved, and we believe DeepSeek's R1 model will create tailwinds for AI adoption. AI should become one of the defining investment trends over the next decade, and we continue to explore ways to provide exposure to this evolving technology in client portfolios.

President Donald Trump began his second term in office with a blitz of policy actions. Since his inauguration on January 20, Trump has signed a slew of executive orders targeting areas such as DEI, immigration, and abortion. As we expected, Trump focused on deportations out of the gate, declaring a national emergency on the US-Mexico border, and issuing a broad ban on asylum for migrants. A showdown with Colombian President Gustavo Petro brought Trump's hardline negotiation style to the forefront. Trump ordered visa restrictions, 25% tariffs on all Colombian incoming goods, which would be raised to 50% in one week, and other retaliatory measures in response to Colombian President Petro's decision to reject two Colombia-bound US aircrafts carrying migrants.[11] Colombia quickly reversed course, agreeing to accept the deportees in the face of steep tariffs.

At the beginning of February, Trump proved he was sincere in his tariff threats, as he enacted tariffs of 25% on Mexico and Canadian goods coming into the US, with an exception for Canadian energy, which had a lower 10% rate.[12] Additionally, a new 10% tariff was enacted on goods from China.[13] President Trump invoked the International Economic Emergency Powers Act (IEEPA) to enact tariffs on Canada and Mexico, claiming that border security created a national emergency. The legality of using IEEPA to enforce tariffs has drawn controversy and will likely be challenged by Trump's political opponents. As tariffs were set to go into effect on February 4, both Mexico and Canada were able to strike a deal with President Trump agreeing to bolster their border security and take other steps to prevent drug trafficking into the US. The proposed tariffs would have likely been inflationary and harmful to US economic growth; however, we believe the tariffs would have proven more punitive towards Mexico and Canada given their economy's larger reliance on trade. Trump's actions suggest that tariff policy is real, not just empty threats. While we have maintained that Trump mainly uses tariffs as a negotiation ploy, he proved his willingness to enact tariffs if his demands are not met. Trump appears to have a firm grasp of his leverage at the negotiation table and is not afraid to use it to push his agenda.

Conversely, tariffs on Chinese goods went into effect but were met with retaliatory trade restrictions from China set to take effect on February 10. The initial effect of the current tariffs will likely prove minimal, but a greater risk looms if the current disputes escalate into a protracted trade war. Geopolitical risk is a major factor behind our underweight towards China in portfolios, and recent events have further supported our view to maintain caution towards investing in the country.

Candidly, we did not expect Trump to use tariff policy so aggressively in the early days of his presidency, given his perceived sensitivity towards inflation. Aggressive tariff policy was a major risk we identified going into 2025, believing it could escalate geopolitical tensions and potentially reignite inflation. Trump's draconian actions show his willingness to accept short-term pain to achieve his long-term objectives. In terms of markets, this creates a heightened sense of political uncertainty, increasing volatility across global equity and currency markets. We believe regional diversification in portfolios will be essential to mitigate these risks. Still, strong corporate earnings growth amid a solid economic backdrop positions US risk assets to continue to perform well. We remain constructive on the economy and markets; however, we focus on investing in high-quality assets to enhance downside protection in client portfolios as global tensions escalate.

11. Cano, Regina Garcia, et al. "White House Says Colombia Agrees to Take Deported Migrants after Trump Tariff Showdown." AP News, AP News, 27 Jan. 2025, apnews.com/article/colombia-immigration-deportation-flights-petro-trump-us-67870e41556c5d8791d22ec6767049fd.

12. Clifton, Daniel. "MEXICO & CANADA TARIFFS: IMPACT & NEXT STEPS." Strategas, 2 Feb. 2025, www.strategasrp.com/Document/Index?strResearchProductID=gXMleUMs7TqsVDtcamPWrw%3d%3d.

13. Id.

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