MARKET COMMENTARY

Rain on the Parade

February 2025

- Market results were mixed in February. U.S. large-cap stocks ended the month down 1.3%, and U.S. small-cap stocks declined 5.3% while U.S. intermediate-term bonds gained 2.2%.
- Consumer spending declined, but wages increased. Inflation remains persistently elevated.
- It remains unclear how much of the decline in bond yields signals optimism about the Department of Government Efficiency's impact on the deficit versus concerns over a growth slowdown caused by tariffs.
- Treasury Secretary Scott Bessent is urging markets and consumers to bear the short-term pain of government spending cuts and tariffs for long-term gains stemming from the anticipated boost in domestic manufacturing and capital investment.

Overview

Markets produced mixed results in February. U.S. large-cap stocks, as represented by the S&P 500, ended the month down 1.3%, while the U.S. small-cap Russell 2000 Index ended February down 5.3%. U.S. intermediate-term bonds fared well, as the Bloomberg U.S. Aggregate Bond Index gained 2.2%.

Higher income and lower spending boosted the personal savings rate

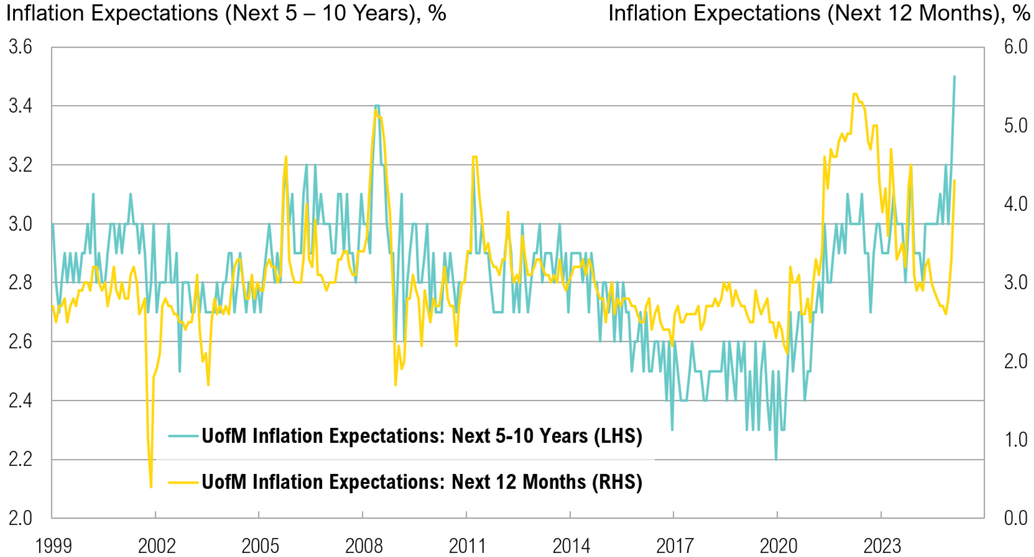
Personal income increased by 0.9%, driven by rising wages and adjustments to social security benefits.[1] Higher income and lower spending boosted the personal savings rate, which climbed to a six-month high of 4.6% in January.[2] Consumer prices ticked up in the first month of the year. The January consumer price index (CPI) report showed headline inflation rising to 3.0% year-over-year, while core inflation also increased, rising to 3.3%. Persistent inflation and unseasonably cold weather weighed on consumer spending as retail sales declined by 0.9% month-over-month in January.

Fed officials appear to be willing to keep interest rates steady

Largely due to the warmer-than-anticipated January inflation report and tariff concerns, inflation expectations rose sharply in February. Longer-term inflation expectations reached a record 3.5%, while short-term (next 12 months) expectations jumped by 1%, rising to 4.3%. This is more than double the official Federal Reserve target of 2%. Minutes from the January 29 Federal Open Market Committee (FOMC) meeting, released on February 19, showed Fed officials willing to hold interest rates steady amid stubborn inflation and uncertainty surrounding economic policy.[3]

Inflation expectations skyrocketed following the warmer-than-expected January print

Both Short- and Longer-Term Inflation Expectations Skyrocketed in February

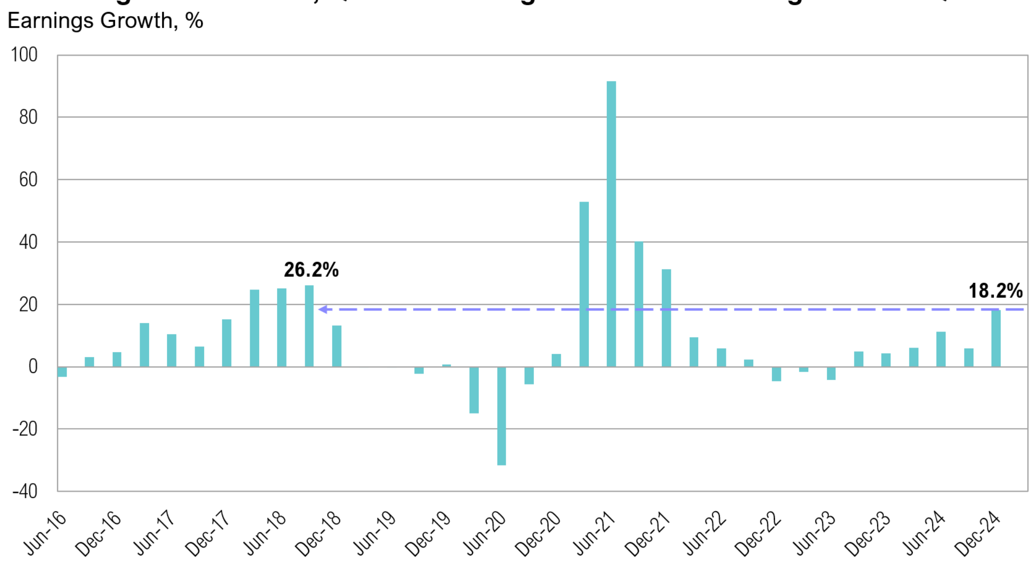


Source: Bloomberg

With over 97% of S&P 500 companies having already reported, earnings growth for the fourth quarter of 2024 notably improved over February, rising from 11.7% at the start of the year to 18.2%.[4] Excluding the COVID-19 pandemic, this represents the strongest quarterly earnings growth for the S&P 500 since the third quarter of 2018, when earnings grew by 26%. Financials (56%), communication services (30%) and consumer discretionary (27%) led the earnings growth.[4] Looking ahead, projections for the first-quarter S&P 500 earnings growth are expected to be 7.5%.[4]

S&P 500 earnings growth for the first quarter of 2025 is expected to be 7.5%

Excluding Pandemic Era, Q4 2024 Earnings Growth Was Strongest Since Q3 2018



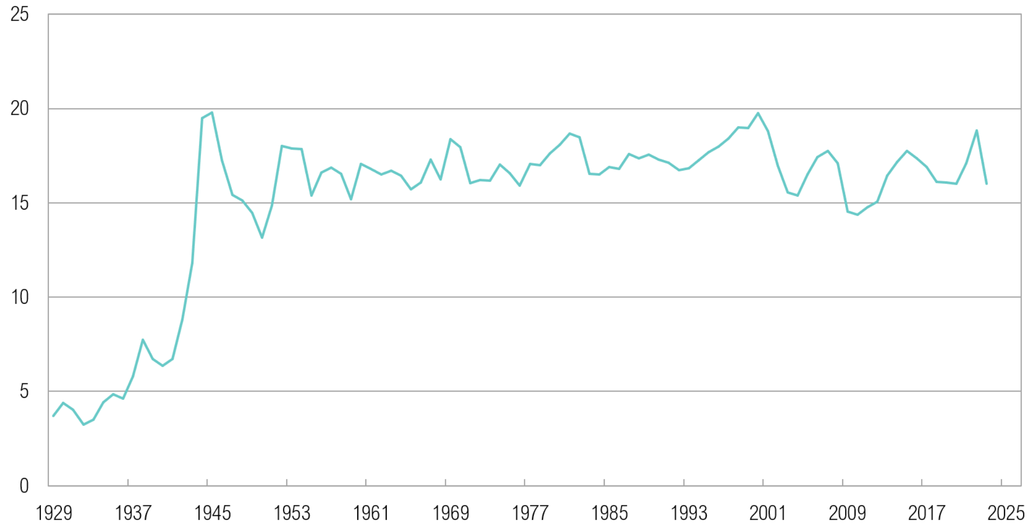
Source: FactSet

Rain on the Parade

The U.S. government fiscal deficit reached $1.8 trillion in the 2024 fiscal year, making it the largest deficit on record for a non-crisis or non-recessionary year. Already, the fiscal deficit for 2025 has surpassed $800 billion, and is projected to reach $1.9 trillion by the fiscal year end.[5,6] Tax receipts as a percentage of GDP have remained steady for over 50 years—but government spending has not. In the words of new Treasury Secretary Scott

Bessent: "We do not have a revenue problem in the U.S. We have a spending problem."[7]

Tax Receipts Relative to GDP Have Remained Relatively Steady for Over 50 Years
Federal Tax Receipts as a % of GDP



Source: Bloomberg

In December, Fed Chair Jerome Powell noted that:

> *"The U.S. federal budget is on an unsustainable path. The debt is not at an unsustainable level, but the path is unsustainable, and we know that we have to change that."*[8]

DOGE claims to have saved the government over $100 billion already

The Trump administration has made it clear that reducing the fiscal deficit is one of its primary objectives. The newly created Department of Government Efficiency, or DOGE, was created to improve government accountability and efficiency through strategic oversight and reform initiatives. DOGE's methods thus far have, at times, been unorthodox, including a parade of often controversial decisions. For example, it offered a "deferred resignation," which approximately 75,000 federal employees accepted in exchange for up to six months of paid leave. It also fired and re-hired essential Department of Agriculture employees to work on the government's response to the ongoing bird flu outbreak in the U.S. and stopping nearly all funding from USAID.[9,10,11,12,13] DOGE claims to have saved the government over $100 billion already.[14]

There is overwhelming support for the government's policies on eliminating wasteful government spending and fraud

Nevertheless, progress has at least been made in shedding light on wasteful government spending. Further, a recent Harvard CAPS-Harris poll of over 2,400 registered U.S. voters found an overwhelming support for the government's policies on eliminating fraud and waste in government spending and cutting government expenditures that were already allocated by Congress.[15] 77% of Americans believe that a full examination of government expenditures is needed, and 83% of Americans (including 72% of Democrats and 94% of Republicans) agreed that spending should be cut.[15]

The poll also found broad support for "placing reciprocal tariffs on countries that have tariffs on U.S. goods."[15] On February 1, President Trump signed executive orders imposing 25% tariffs on imports from Canada and Mexico and a 10% tariff on imports from China. Following the announcement, tariffs were temporarily paused for one month after both Canada and Mexico agreed to tighten border security to curb the flow of illegal drugs into the U.S.[16,17] In early March, the temporary pause was lifted, and an additional 10% tariff was added to Chinese goods.[18,19]

The U.S. trade deficit surged to a record high on pending tariff concerns

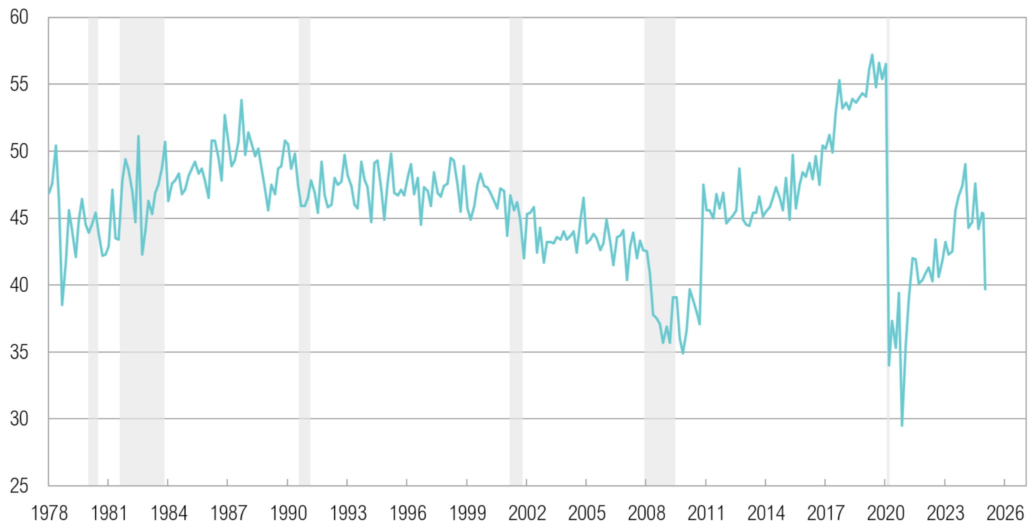
While the secondary GDP estimate showed economic growth holding steady at an annualized 2.3%, concerns about slowing growth increased over the month, as trade policy uncertainty rained on the parade of continued economic expansion. The Atlanta Fed's GDPNow estimate for the first quarter of 2025 sharply dropped from 2.9% in the beginning of February, to end the month at -1.5%.[20] A key reason for the sharp decline was a notable increase in U.S. trade deficits as imports surged in an effort to avoid forthcoming tariffs.[21] Notably, a substantial portion of import gains was driven by the movement of gold from Europe to the U.S. to avoid tariffs.[22]

Bearish sentiment notably increased at the end of February

Consumer confidence also dropped by seven points in February, recording the largest monthly decline since August 2021 as pessimism about the future returned.[23] The number of consumers planning a vacation in the next six months plummeted by 6%, the largest monthly drop outside of the COVID-19 pandemic. Reports show that corporate capital spending plans have started to reverse, as uncertainty on the economic outlook grows.[24] The American Association of Individual Investors (AAII) sentiment survey showed bearish sentiment rising to 61% in the last week of February, despite nearly 40% of respondents saying that the current state of the economy was "good" and the S&P 500 ending the month 3% off its all-time high.[25]

U.S. Consumer Domestic Vacation Plans Sharply Dropped in February

Survey Respondents Planning a U.S. Vacation Within 6 Months, %



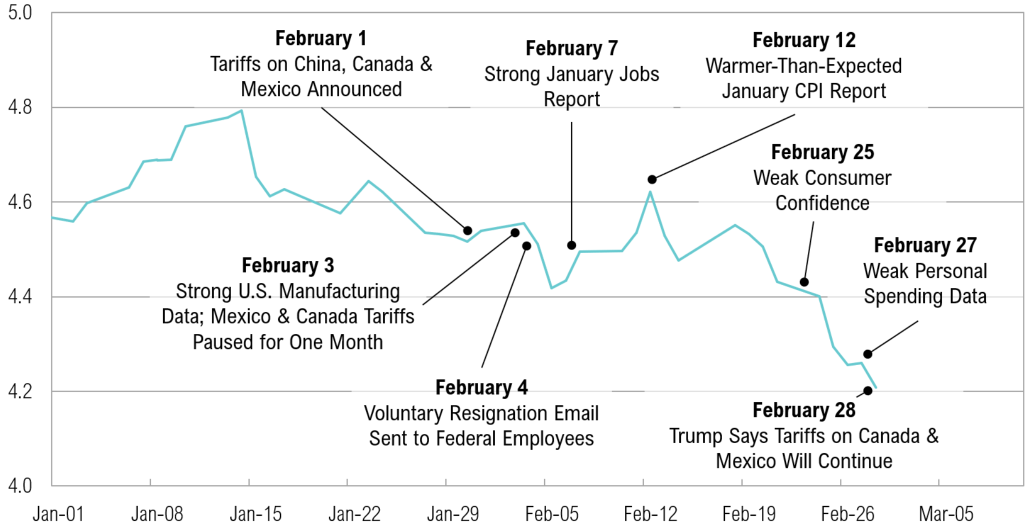
Source: Bloomberg, Conference Board. Survey data from the February 2025 Conference Board Consumer Confidence Survey.

Credit spreads remain tight and continue to signal economic stability

Bond yields declined throughout February, easing from 4.5% to end the month at 4.2%. Whether or not declining bond yields reflect potential optimism about DOGE's impact and its ability to trim the fiscal deficit or whether they reflect rising concerns about a possible growth slowdown remains to be seen. Credit spreads remain tight—and continue to signal economic stability and the potential for continued expansion.

Longer-Term Treasury Yields Declined in February

10-Year Treasury Yield, %



Source: Bloomberg

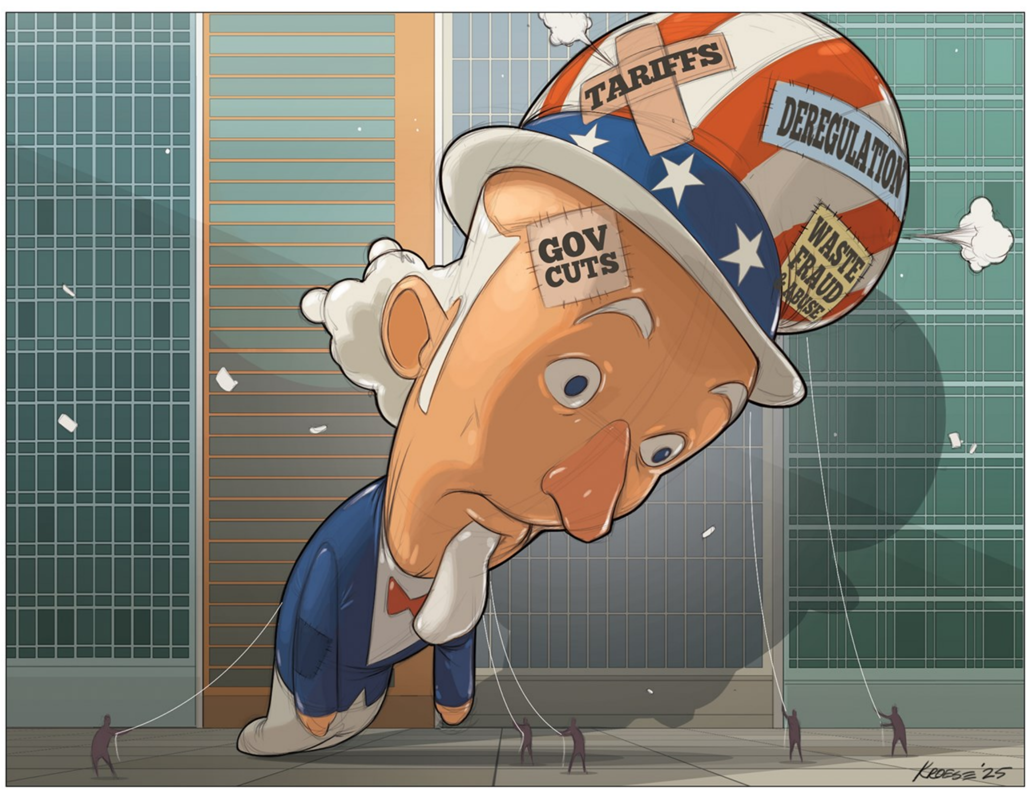
The 10-year Treasury yield ticked lower in February

Markets are being encouraged to overlook short term pain for longer-term gain

The Trump administration is urging markets to overlook the short-term pain of deficit cuts and potential tariff consequences, focusing instead on the expected boost in small business spending, domestic manufacturing, and capital investment. As Treasury Secretary Bessent pointed out:

> *"Wall Street can continue to do fine. But we have a focus on small business and the consumers. So we are going to rebalance the economy. We're going to bring manufacturing jobs home."*[26]

For now, these anticipated benefits appear to be overshadowed by the immediate effects of deficit reductions and tariffs.



Source: SpringTide, Noah Kroese

Markets

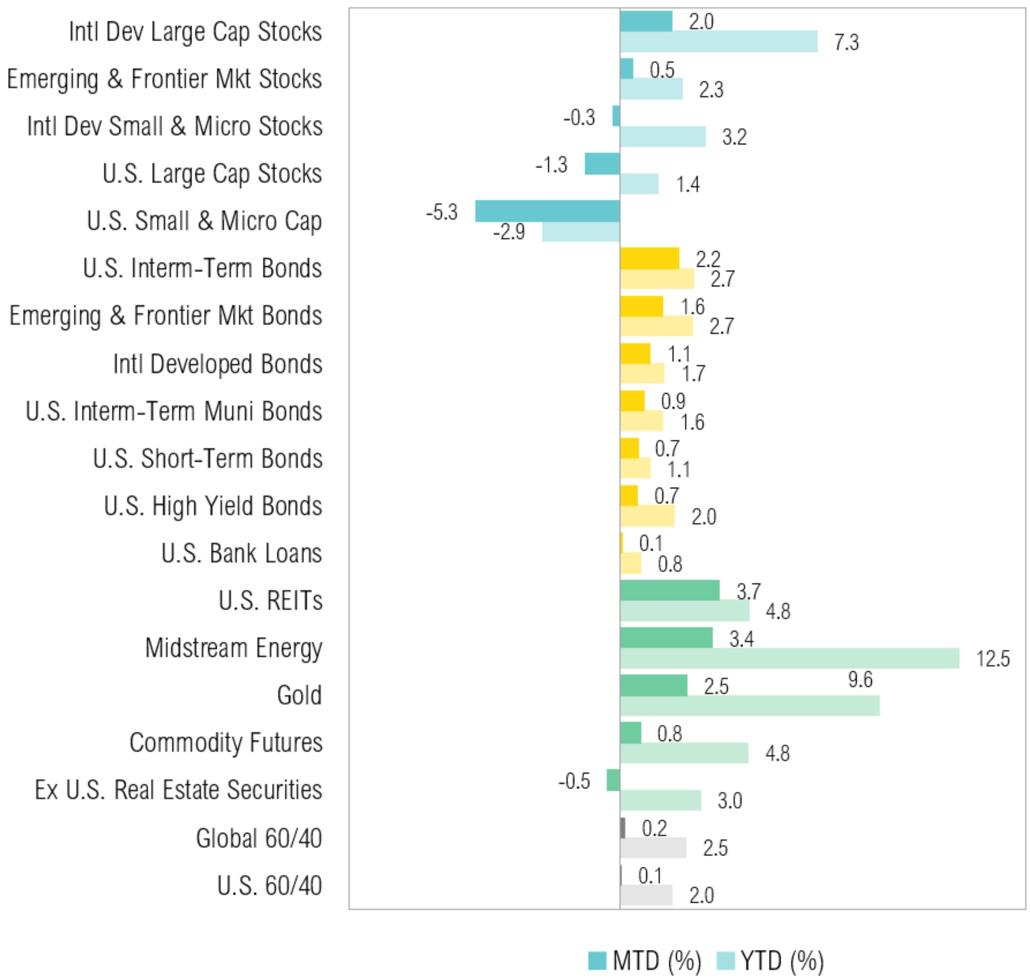
For the second consecutive month, international equities fared better than their U.S. counterparts. U.S. large-cap stocks ended the month down 1.3% while international developed large cap stocks gained 2.0%. Similarly, while U.S. small-cap stocks ended the month down 5.3%, international developed market small cap stocks declined by only 0.3%. International developed market gains were driven mostly by European countries, including Spain (+10%), Poland (+8%) and Finland (+4%). U.S. intermediate-term bonds ended February up 2.2%, while developed market bonds gained 1.1%.

Reports suggest a potential shift in Beijing's approach to the private sector

In international news, Chinese markets ended February up nearly 12%, despite tariff concerns. Recent reports suggest a potential shift in Beijing's approach to the private sector, as Chinese President Xi Jinping hosted a high-profile meeting with top entrepreneurs, including representatives from DeepSeek and Alibaba founder Jack Ma, amongst others. The meeting fueled speculation about a possible revival of China's technology industry and renewed support for private enterprises.[27]

U.S. intermediate-term bonds fared well, gaining 2.2%

February 2025 Key Market Total Returns



Source: Bloomberg

Looking Forward

The current administration aims to reduce the deficit to extend the Tax Cuts and Jobs Act beyond its scheduled expiration at the end of 2025. It has also proposed eliminating income taxes on Social Security benefits, overtime and tips, which would reduce government revenue by $1.8 trillion over the next ten years.[28,29] Achieving these objectives requires curtailing government spending to keep longer-term interest rates contained, in hopes of sustaining the current economic expansion.

Broader disruptions may be contained if markets believe in the government's approach

The administration is encouraging markets to look beyond the near-term pain posed by deficit cuts and tariff consequences, focusing instead on the potential boost in small business spending, domestic manufacturing, and capital investment that may result. As long as markets see sufficient evidence that this approach is working, broader disruptions may remain contained. However, if these efforts falter, the parade may be called off.

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Interm-Term Muni Bonds: Bloomberg 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Interm-Term Bonds: Bloomberg U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Global Aggregate Bond TR Index.

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MAGNUS FINANCIAL GROUP

90 Park Avenue, Suite 1800,
New York, NY 10016

(800) 339-1367

service@magnusfinancial.com