Wealth Advisory Market Update

March 4, 2025

Market Update

Equities:

The market, as measured by the S&P 500, declined by 1.3% for the month. Volatility increased as uncertainty surrounding the new administration's tariff policies created market anxiety. Another market moving event was Nvidia reporting earnings. They reported earnings that exceeded both top- and bottom-line expectations; however, concerns over declining margins led to a significant selloff. The stock dropped more than 15% over the last week of February, dragging the broader market down with it. Currently, momentum and meme stocks have been experiencing substantial declines, while value-oriented stocks have outperformed. Given that growth and momentum stocks are historically overvalued, we may continue to see a shift toward value investments.

Over the past two years, market valuations have surged. Historically, fundamentals have not been reliable indicators of market tops and bottoms, but they do provide guidance on how aggressively we allocate equities. Given current valuation metrics, we believe a more defensive investment approach is prudent. Several indicators support this view. The cyclically adjusted price-to-earnings (CAPE) ratio, which measures price relative to the 10-year average of earnings, stood at 37.9x as of December. For context, the only instances of a higher reading occurred during the dot-com bubble (44.2x) and in 2021 (38.6x). The historical average CAPE ratio is 17.6x. In addition to stretched valuations, sentiment and positioning are also at extreme levels. Both retail investors and fund managers are holding historically low cash levels and maintaining high equity allocations, which often signals proximity to a market peak.

The market's recent rally has been driven by a concentrated group of AI-related companies. These technology stocks have consistently traded at elevated multiples, yet, in our view, their return on investment (ROI) has not justified these valuations. Companies continue to make significant expenditures on artificial intelligence (AI) without demonstrating meaningful improvements in margins or earnings-accretive products. While AI may and most likely will prove profitable, the sharp increase in valuations and expected earnings appears premature—reminiscent of the dot-com bubble. We are beginning to see early signs of slowing capital expenditures, as evidenced by Microsoft's recent decision to cancel certain data center leases. This suggests growing concerns about AI demand and profitability. Given these dynamics, we remain underweight in the technology sector but continue to identify value opportunities in other areas of the market.

Economic Indicators and Monetary Policy:

The Federal Open Market Committee (FOMC) did not convene this month, but the release of meeting minutes provided insight into policymakers' views. The notes reaffirmed that the FOMC remains in a "wait-and-see" mode, requiring further progress on inflation before considering rate cuts. Although Federal Reserve officials have not explicitly discussed tariffs in recent public statements, the minutes indicate concerns that proposed tariffs and mass deportations could pose inflationary risks. These policies, which are central to the Trump administration, are unlikely to change.

One of the most notable takeaways from the minutes was the potential slowdown or pause in the Federal Reserve's balance sheet runoff. This marks a potential shift in the ongoing Quantitative Tightening (QT) campaign, which has aimed to reduce liquidity in the financial system to combat inflation. Paradoxically, while the Fed remains concerned about inflation, it is also contemplating actions that would increase liquidity—an apparent contradiction.

On the economic front, recent data suggests signs of a consumer slowdown. In our previous update, we highlighted that consumer spending has been largely fueled by debt, while personal savings rates have continued to decline. The latest retail sales data reinforces this concern. Wall Street had anticipated a 0.2% decline in retail sales, but the actual drop was 0.9%.

Additionally, the control group—used for GDP calculations—fell by 0.8% versus an expected 0.3% increase. This suggests that consumers may be reaching their spending limits, potentially signaling an economic slowdown.

On the geopolitical front, the United States and Russia have initiated discussions aimed at negotiating a peace agreement with Ukraine. While these talks represent a significant step toward ending the prolonged conflict, it remains unlikely that a resolution will be reached in the near term. We expect geopolitical tensions to continue serving as a market headwind.

Strategy:

As valuations remain elevated, we will adhere to our long-term investment discipline. We will continue identifying companies that trade below their intrinsic value and offer an attractive risk/return profile.

Interest rates, as measured by the 10-year U.S. Treasury yield, have declined by 20 basis points since the beginning of the month. Over the long term, we continue to anticipate lower rates and believe the current environment presents an opportunity to extend duration within fixed-income portfolios. We will maintain our focus on high-quality credits, as credit spreads remain tight and do not offer sufficient compensation for the associated risks.

As we navigate this complex investment landscape, we appreciate the opportunity to collaborate and remain committed to prudent investment management.

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