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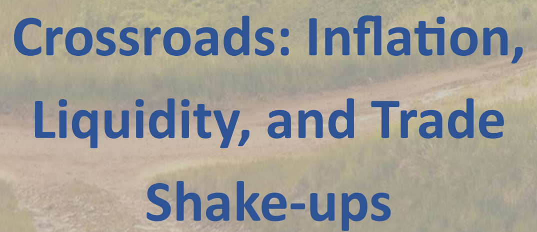

Crossroads: Inflation, Liquidity, and Trade Shake-ups

FEBRUARY 2025 MARKET PERSPECTIVE

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The U.S. economy enters 2025 at a pivotal moment. A robust labor market and resilient corporate profits are keeping the soft-landing narrative alive, but inflation's persistence and new policy uncertainties pose fresh challenges. The Federal Reserve remains watchful, holding interest rates steady as it weighs inflation risks and economic stability. Meanwhile, aggressive trade policies and liquidity concerns in fixed income markets add layers of complexity for investors. How do these forces shape the path forward for equities, bonds, and alternative investments?

As we evaluate these critical factors, it becomes clear that 2025 will demand a flexible approach to asset allocation. The balance between inflation control and economic growth, shifting trade relationships, and the potential for liquidity stress will all play a role in shaping the market's trajectory. Investors must stay agile, focusing on quality, diversification, and careful positioning to navigate the evolving landscape. A disciplined strategy that accounts for both opportunities and downside risks will be essential in navigating the complex financial environment ahead.

The Fed's Tightrope Walk: Balancing Inflation and Growth

The Federal Reserve continues to walk a fine line between sustaining economic momentum and controlling inflation. January's data showed core inflation rising 0.3%, reinforcing the Fed's hesitancy to lower rates prematurely. While a rate cut remains possible in 2025, policymakers have signaled that it won't happen until at least July—and even then, only if inflation is trending decisively lower. The central bank's primary concern remains preventing a resurgence of inflation that could destabilize financial markets and economic growth.

Inflation remains persistent, fueled by rising wages, deglobalization trends, and lingering supply chain constraints. The recent round of trade tariffs is expected to push up the cost of imported goods, exacerbating inflationary pressures. With inflation still above the Fed's 2% target, Chair Powell has reiterated the Fed's commitment to ensuring price stability before considering any rate reductions. The prolonged high-rate environment will continue to ripple through the economy, impacting credit-sensitive sectors and corporate borrowing costs. The Fed's cautious approach underscores the challenges of balancing economic stability with inflation control, making it clear that investors should prepare for a prolonged period of elevated rates.

The Liquidity Squeeze: A Storm Brewing in Fixed Income

While the Fed has paused its rate hikes, its quantitative tightening (QT) program continues to reduce liquidity. Historically, March, June, and September have been periods of heightened

funding stress, and June is shaping up to be a key risk window for a potential credit squeeze. The contraction in liquidity is making it increasingly difficult for financial institutions and corporate borrowers to secure funding at favorable rates.

Liquidity concerns stem from multiple factors. The Fed's balance sheet reduction has drained excess reserves from the banking system, increasing the risk of liquidity shortages, particularly among regional banks. The Secured Overnight Financing Rate (SOFR) remains stable for now, but a mid-year spike could force the Fed's hand. Additionally, corporate credit markets may face an uptick in defaults if economic growth slows, increasing investor caution around lower-quality fixed income assets. Historical data suggests that liquidity crises often lead to broader market stress, making it imperative for investors to remain vigilant and proactive in adjusting their portfolios.

For investors, this means prioritizing quality over yield remains a prudent strategy. Defensive positioning in fixed income markets and careful management of duration exposure will be key to weathering potential liquidity disruptions. Investors should consider increasing allocations to investment-grade corporate bonds and government securities to mitigate risks associated with deteriorating credit conditions.

High Hopes or House of Cards? The Equity Market's Test

The equity market is priced for perfection, with the S&P 500 trading at ~22x forward earnings—a level that assumes continued economic resilience, stable inflation, and eventual Fed easing. However, risks to this bullish narrative remain, particularly as monetary policy remains restrictive and economic headwinds intensify.

Much of the market's gains have been concentrated among the "Magnificent 7" tech giants, whose combined earnings contribution (25.5%) remains well below their market-cap weight (32.1%). This concentration raises concerns about sustainability, particularly if economic conditions deteriorate or interest rates remain higher for longer. While these companies continue to drive market sentiment, cracks are beginning to show in earnings growth expectations.

On the other hand, sector rotation has begun, with financials, industrials, and select small-cap stocks seeing improved performance, signaling a potential broadening of market leadership. Investors should monitor earnings trends closely. While tech dominance continues, broadening participation from value-oriented sectors may provide more stability in the event of market volatility. Small caps could benefit from domestic production incentives, but only if they can secure access to affordable funding. Given the higher risk premium in equity markets, a focus on

high-quality companies with strong balance sheets and consistent earnings growth remains crucial.

The Tariff Tango: Economic Protection or Inflation Driver?

The trade landscape is undergoing a significant shift under the second Trump administration. New tariffs of 25% on Mexican and Canadian imports and 10% on China, coupled with the elimination of small-value import exemptions, are reshaping global supply chains. While the administration argues that these policies will strengthen domestic production and national security, the market consequences are clear: higher inflation and increased volatility.

Import costs are rising, multinational corporations with global supply chains are facing headwinds, and currency markets have responded with a stronger U.S. dollar. While domestic industries may benefit from protectionist measures, the broader economic impact remains uncertain. Short-term, these tariffs could add to inflationary pressures, delaying Fed rate cuts and putting stress on consumers. Multinational corporations may see margin compression as supply chain costs rise. However, small-cap firms focused on domestic production may find new opportunities if they can navigate labor and capital constraints. Investors should monitor trade developments closely, as additional policy changes could further disrupt economic stability.

The Inflation Comeback: Is the Fight Really Over?

Despite a cooling trend, inflation remains a pressing concern. Essential goods and services have risen 23.1% over four years, outpacing wage growth (17.1%), which continues to weigh on consumer sentiment. The risk of a second inflationary wave looms as wage increases, supply chain shifts, and trade barriers converge. Rising costs in critical sectors such as housing, healthcare, and energy add another layer of complexity to inflation management.

Inflation expectations remain elevated, particularly in housing, healthcare, and energy. Major labor negotiations have resulted in significant wage gains, such as Boeing machinists securing a 32% increase over four years. These rising labor costs could feed into broader consumer price pressures, prolonging the Fed’s inflation fight. Investors should be prepared for ongoing price volatility, and those looking for hedges against inflation may find gold and real assets increasingly attractive.

The Road Ahead: Key Market Signals to Watch

The market is walking a tightrope between optimism and underlying risks. Inflation remains a challenge, monetary policy is uncertain, and trade policies are reshaping economic conditions. Investors must remain vigilant, tactical, and diversified to navigate the uncertainties ahead.

Interesting Side (Statistical) Note

The S&P 500 wrapped up January with a solid total return of 2.8%, marking the 60th instance in 153 years (since 1872) where the index started the year with gains of at least this magnitude.

Looking at the broader dataset, the S&P 500 has ended the year in positive territory 74% of the time, with an average annual return of 11.0%. However, when January produces a return of at least +2.8%, the likelihood of a positive year jumps to 85%, and the average return climbs to 18.9%. Further analysis reveals that when the index posts a 2.8% gain in January, there is a 75% probability that it will deliver a return of at least 10.3% by year-end—substantially higher than the typical 47% probability of reaching that return level across all years.

While past performance does not dictate future results, the statistical advantage of a strong January suggests a favorable outlook for equities. Every month that passes with the market remaining in positive territory only strengthens the probability of another strong year for stocks, reinforcing investor confidence in sustained momentum.

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