Exencial Wealth Advisors™

February 2025

Market Update

January 2025 was a busy month for markets and for the government under a new administration. In markets, it was a clean sweep as every broad asset class moved higher – in contrast to December in which nearly everyone was lower. The S&P 500 was up 2.8%, but value (+4.6%) outperformed growth (+2.0%). The announcement that the Chinese AI model Deepseek may be superior to US models cooled US growth returns. US small caps were up 2.6%, and surprisingly developed international markets were up 5.3% (emerging markets were up 1.8%), which were fueled purely by market gains as the US dollar was flat for the month. Bond returns were up 0.5%, and most fixed income asset classes were up between 0.5% and 1.0%.

Inflation in January accelerated back up to 3% and has clearly not been controlled. Part of the problem has been caused by government spending and deficits that have no parallel in our history – especially during peacetime and very low unemployment levels. The other part of the problem has been a Federal Reserve that was slow to react to accelerating inflation and money supply growth. They did raise rates at a historic pace to get ahead of the curve, but the damage had been done. Since the start of May in 2020, US money supply grew 35% and helped boost CPI inflation by 25% and housing inflation by 50% as of the end of January.

We don't envy or want the Fed's job. They are the referees of a complex financial game, and when they call a fair game, it often means that the players from all teams are upset with them. But inflation has consistently remained above the 0% to 2% target. Over the last 98 years inflation has averaged 3% annually, and that includes the initial years of the Great Depression in which we experienced nearly 30% cumulative deflation. Researchers such as Milton Friedman blamed the Fed for not increasing money supply (along with the increase of the supply of gold under the gold standard) in those depression years. Today we have the opposite problem - a government pushing inordinate amounts of money into the economy and a Fed that is not taking money back out of the system fast enough. The end of the globalization era is also inflationary as reshoring brings production back to higher cost areas of the world. Inflation risk remains elevated for both the near-term and long-term under current conditions.

Looking at rates and valuations across the market as of the end of January, we see yields on investment grade bonds at roughly 5%. This may be slightly low with inflation at 3% but appears reasonable overall. US small caps are trading slightly under their average valuations and US mid-caps just slightly over. These look fairly priced with reasonable future expected returns. International and US value stocks are trading at a premium to their average valuations but still appear reasonably priced under current market conditions. The US large cap space, and more specifically the US growth space, is trading at a 60% premium above average valuations. This has led many to lower their expected return forecasts for this part of the market.

Our base case for 2025 is that GDP (Gross Domestic Product) will slow from current levels. While we didn't experience the recession many feared, higher interest rates and higher debt pressure on US households will have a slowing effect on spending and growth. Household net worth will remain bolstered by home values and investment accounts which have remained high. Inflation may have become entrenched above the Fed's 2% target.[2] Markets and interest rates generally appear to be at appropriate levels with the exception of the largest and growthiest US companies which are trading 2-3 standard deviations above their typical valuations.[3]

Sources & Disclosures

1. *All earnings data comes from Standard and Poors' S&P 500 Earnings and Estimates Report as of 1/31/2025.*

2. *All economic data comes from Federal Reserve Economic Data (FRED) as of 1/31/2025*

3. *Asset class performance numbers come from Morningstar as of 1/31/2025.*

The S&P 500® is widely regarded as the best single gauge of large cap US Equities There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

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