ECONOMIC & INVESTMENT PERSPECTIVES

March 3, 2025

FEBRUARY: FALLING YIELDS, VOLATILE STOCKS

FED EXPECTATIONS: FEWER RATE CUTS AHEAD?

Figure 1: 2/28/2025 Returns (source: FactSet, Morningstar)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	2.2%	2.8%	5.8%	-2.7%	4.6%
Investment Grade Corp Bonds	LQD	2.4%	3.0%	6.4%	-3.9%	5.3%
U.S. 20+ YR Treasuries	TLT	5.7%	6.2%	2.2%	-9.1%	8.9%
Muni Bonds	MUB	1.3%	1.3%	2.8%	-1.0%	2.6%
US High Yield	HYG	1.0%	2.3%	10.0%	-0.3%	6.0%
Non-US Corp Bonds	IBND	0.8%	1.4%	2.1%	-8.6%	3.6%
Emerging Markets Bond LC	EMLC	0.9%	2.9%	1.6%	-7.4%	3.1%
Global Equity						
ACWI Global Equity	ACWI	-0.3%	2.8%	15.3%	-2.7%	15.9%
ACWI Global Equity ex US	ACWX	2.5%	6.1%	10.2%	-4.6%	11.0%
International Developed	EFA	3.0%	7.9%	8.9%	-3.5%	10.4%
Emerging Markets	EEM	1.1%	3.3%	10.6%	-8.9%	9.7%
Global Equity by Region						
United States	VTI	-1.9%	1.1%	17.5%	-3.4%	19.8%
Europe	IEUR	4.3%	11.0%	11.2%	-3.0%	12.5%
Asia ex-Japan	AAXJ	1.4%	2.1%	13.9%	-10.4%	12.8%
China	MCHI	10.7%	14.3%	40.6%	-10.4%	39.5%
Japan	BBJP	0.3%	2.0%	1.7%	-7.7%	11.8%
Latin America	ILF	-2.4%	7.1%	-14.8%	-22.9%	7.5%
US Equity						
US S&P 500	IVV	-1.3%	1.4%	18.6%	-3.1%	20.3%
NASDAQ 100 QQQ	QQQ	-2.7%	-0.6%	16.4%	-6.0%	23.0%
US Large Growth	IWF	-3.6%	-1.7%	19.8%	-5.9%	25.2%
US Large Value	IWD	0.4%	5.0%	15.7%	-3.0%	15.1%
US Eqwt S&P 500	RSP	-0.6%	2.8%	12.4%	-4.2%	13.4%
US Mid Cap	IJH	-4.3%	-0.7%	8.8%	-9.4%	10.5%
US Small Cap	VTWO	-5.2%	-2.8%	6.9%	-12.4%	12.2%

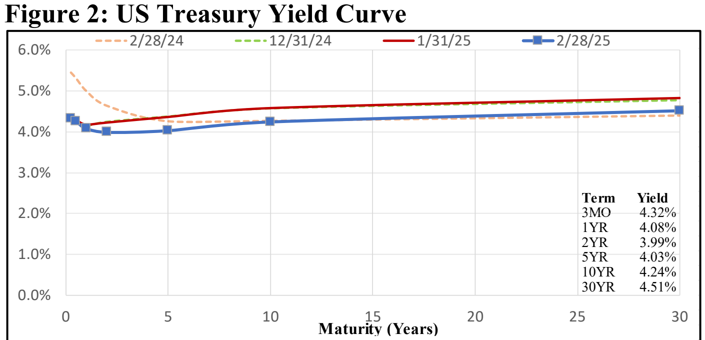
US stocks retreated from all-time highs in late February after several surveys of consumer confidence weakened amid heightened inflation worries (tariffs, egg prices, stubborn inflation), reigniting economic growth and recession concerns. Equity returns outside of the US were strong as the dollar fell. Performance highlights for February and year-to-date (YTD) are below.

- Bonds: The bond market continued to reverse post-election trends toward higher rates and a stronger dollar this month. The US Aggregate index (AGG) rose 2.2% (+2.8% YTD) as yields declined with renewed expectations for further Fed rate cuts. Long-term Treasuries (TLT) are very sensitive to interest rates, rising 5.7% (+6.2% YTD). Corporate bonds (LQD) rose 2.4% (+3.0% YTD); high yield (HYG) rose 1.0% (+2.3% YTD).
- Global equity (ACWI): -0.3% in February (+2.8% YTD).
- US Equity: The broad market (VTI) fell 1.9% (+1.1% YTD), and the S&P 500 (IVV) lost 1.3% (+1.4% YTD). Small stocks (VTWO) under-performed amid rising economic uncertainty, down 5.2% this month (-2.8% YTD). The "Magnificent 7" stocks faltered, leading the Consumer Discretionary (XLY), tech (XLK) and Communications (XLC) sectors lower, while more defensive and interest rate-sensitive sectors were strong.
- Non-US Equity: Non-US stocks continued to rebound in February. Developed markets (EFA) gained 3.0% (+7.9% YTD), led higher by Europe (IEUR +4.3%, +11.0% YTD). Emerging market stocks (EEM) gained 1.1% (+3.3% YTD), but returns varied widely: Chinese stocks were up 10.7% this month (+14.3% YTD) while stocks in India (INDA) were down 5.7% (-8.6% YTD); Latin American stocks posted mixed returns.

Interest Rates and the Economy

Interest rates declined in February as consumer sentiment weakened amid elevated inflation expectations, raising concerns about US economic growth. Inflation remains stubborn (January CPI +3.0% year-over-year), but job growth appears to be moderating (+143,000 jobs in January, unemployment 4.0%, fewer job openings, modestly rising unemployment claims). Investors continue to focus on incoming economic data to calibrate expectations for future rate cuts with three more 0.25% cuts expected this year. The yield curve (Figure 2) plots the interest rates for various US Treasury maturities. US 10-year Treasuries now yield 4.24%.

Figure 2: US Treasury Yield Curve

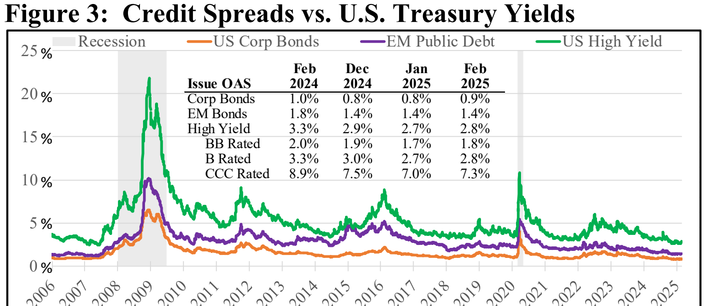


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between their yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism; high or widening spreads signal fear. Spreads widened marginally this month, reflecting the "risk off" tone of US markets.

- Investment grade corporate bond spreads were widened to +0.9% but have been fairly stable over the past year.
- High yield (non-investment grade) spreads widened to +2.8% last month but are down significantly from +3.3% a year ago. Spreads of the riskiest bonds (rated CCC & below) widened to +7.3% but are well below the +8.9% spreads one year ago.
- Emerging market spreads were steady at +1.4% but have tightened over the past year; investors see low risk in EM debt.

Figure 3: Credit Spreads vs. U.S. Treasury Yields

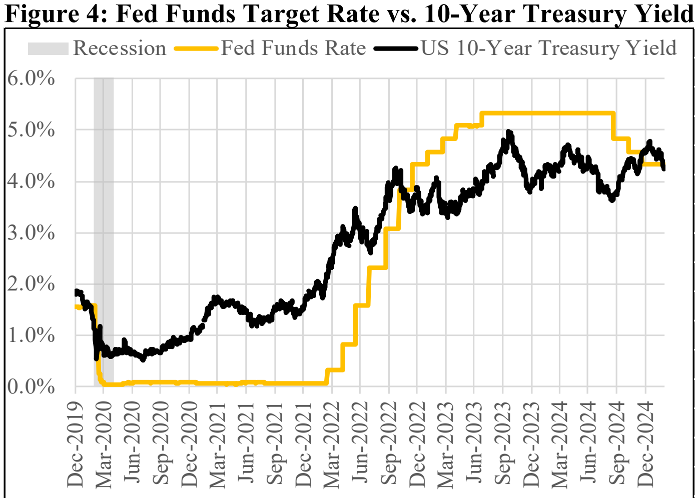


Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Fed Expectations: Inflation & Employment

Markets continue to be driven by changing expectations for the future path of interest rates. The Federal Reserve (Fed) began cutting rates in September, decreasing the Fed Funds target rate by a total of 1.00% by the end of 2024 (current target range: 4.25-4.50%) but have signaled reluctance to cut rates further due to uncertainty regarding inflation, employment and economic growth. While short-term rates have been stable so far in 2025, long-term rates have been volatile, as illustrated in Figure 4.

Figure 4: Fed Funds Target Rate vs. 10-Year Treasury Yield

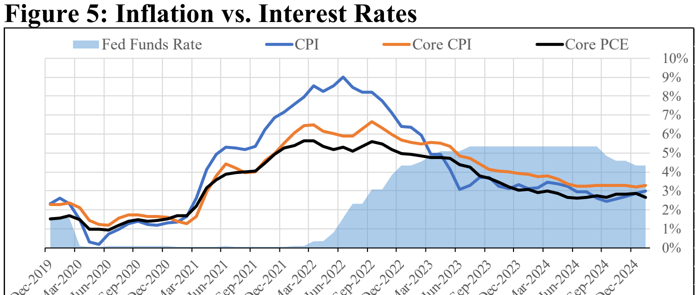


Source: Board of Governors of the Federal Reserve System via FRED

The Fed controls short-term rates, but longer-term yields are market-driven, rising and falling based on investors' expectations for future growth, inflation and Fed policy. Interestingly, as the Fed began cutting rates in September, the 10-year Treasury yield began to rise as strong economic growth, labor market resilience and stubbornly elevated inflation tempered enthusiasm for aggressive Fed cuts. The 10-year yield continued to rise after the US elections with uncertainty regarding the impact of the new administration's policies on inflation (tariffs, immigration, etc.) and expanding debt and deficits (tax cuts). More recently, the 10-year yield has reversed course, moving lower after weaker employment data and sagging consumer confidence raised concerns about economic growth (increasing the odds of more rate cuts).

Investors currently expect two or three more Fed rate cuts (0.25% each) by the end of this year, which would bring the Fed Funds Target Rate down below 4.00%. As we can see from volatile longer-term rates, expectations evolve based on incoming economic data, especially inflation and employment reports (the Fed's dual mandate). Figure 5 illustrates recent inflation trends.

Figure 5: Inflation vs. Interest Rates

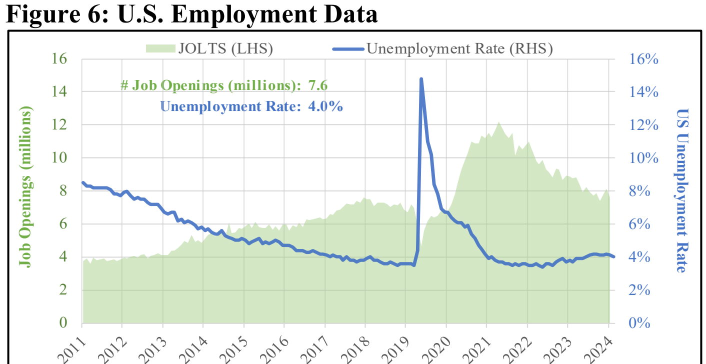


Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Board of Governors of the Federal Reserve System

- CPI: Headline inflation peaked at 9.0% in June 2022 but has declined to 3.0% as of January; recent progress has been muted.
- Core CPI: Excluding food and energy, the most volatile components of inflation, core CPI inflation has declined from a peak of 6.6% to 3.3% year-over-year; recent progress is muted.
- Core PCE: Personal Consumption Expenditures excluding food and energy (the Fed's preferred inflation metric), has fallen from 5.6% to 2.6%. Data over the last three months suggests an annual run rate of 2.4%, above the Fed's 2% target.

The current Fed Funds target rate is above the rate of inflation (positive real interest rates), suggesting that Fed policy is still restrictive. Despite this, the economy has remained resilient. Real GDP (Gross Domestic Product, the value of all final goods and services produced in the US, net of inflation) grew 2.8% last year, well above the 2.4% average annual rate during the 2011-2019 economic expansion. The US job market appears to be in balance (Figure 6 below); unemployment remains historically low (4.0%) despite a large decrease in the number of unfilled job openings.

Figure 6: U.S. Employment Data



Source: US Bureau of Labor Statistics via FRED

Recent data, however, has raised concerns, including downward revisions to 2024 job growth, lower-than-expected job growth in January (+143,000 jobs), a modest uptick in weekly unemployment claims, and the steady drumbeat of government layoffs. Because consumer spending drives two-thirds of the US economy, investors and the Fed will continue parsing every employment report and metric to gauge the health of the consumer.

Bottom Line

Investors remain focused on interest rates, analyzing each new economic data point to assess if the Fed will continue cutting interest rates and by how much. In general, lower interest rates tend to be good for the economy, fueling growth and investment, but a growth scare can also result in Fed rate cuts. This appears to be the case over the past month, as interest rates and the stock market fell after weakening employment and consumer confidence data.

Investors and the Fed are faced with heightened uncertainty regarding inflation, employment and growth as the new administration's policies are still being negotiated and implemented by Congress (tax policy, government spending, immigration, tariffs, etc.). Markets will likely remain volatile in the interim, so diversification remains critical, as always. While most investments outside of the US have under-performed over the past decade, we are starting to see evidence of rotation. US stocks are up 1% so far this year, but European equities are up 11%. Emerging market stock returns are mixed, but China is up 14% and Latin American equities have rebounded as well. Whether these trends are sustainable or simply a reversal of the initial post-election trend (America first) remains to be seen. Meanwhile, investors will remain hyper-focused on incoming economic data for clues.

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