Rain on the Parade

February, 2025

Summary

- 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 while Inflation remained persistently elevated.
- Bond yields declined, signaling either optimism about the Department of Government Efficiency's impact on the deficit, or potential 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.

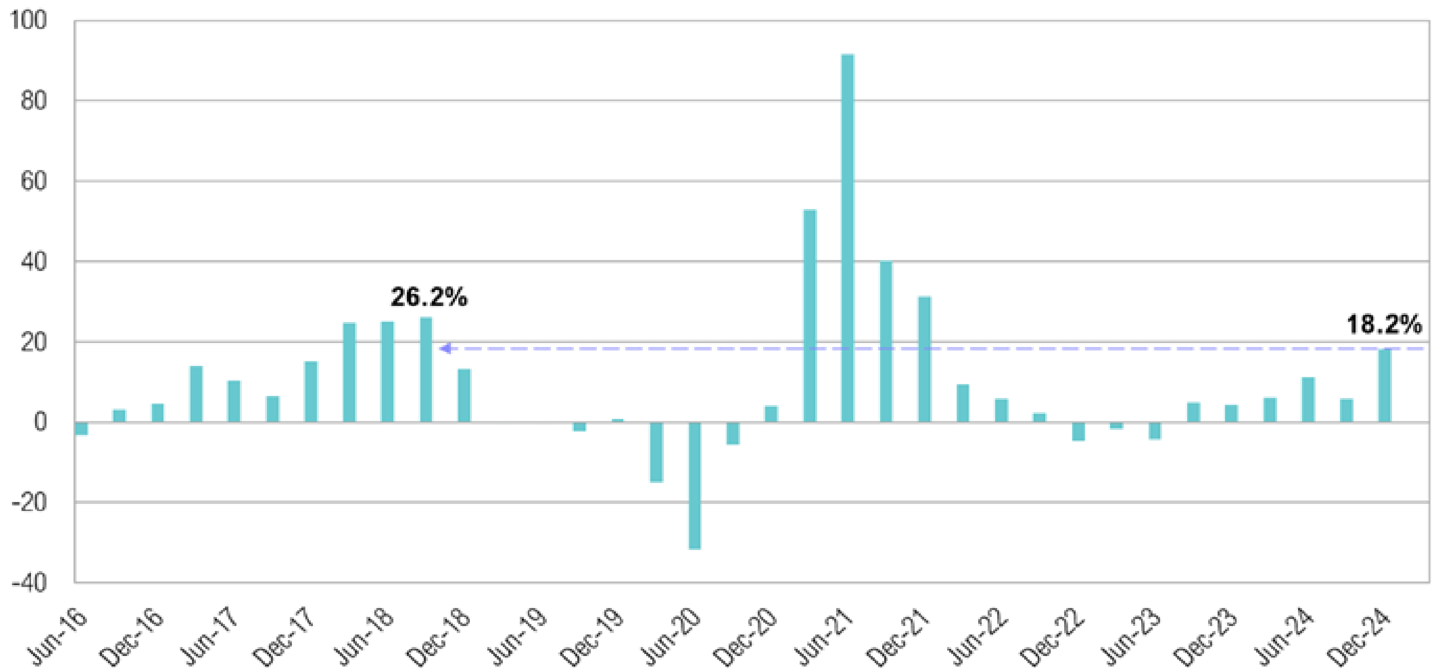
Overview

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%.

Personal income increased by 0.9%, driven by rising wages and adjustments to social security benefits. Higher income and lower spending boosted the personal savings rate, which climbed to a six-month high of 4.6% in January. 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.

Inflation expectations rose sharply in February, largely due to the higher-than-anticipated January inflation report and tariff concerns. 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.

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



Source: FactSet

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%. Excluding the COVID-19 pandemic, this represents the S&P 500's strongest quarterly earnings growth since the third quarter of 2018. Financials (56%), communication services (30%) and consumer discretionary (27%) led the earnings growth. Looking ahead, projections for first-quarter S&P 500 earnings growth are expected to be 7.5%.

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The U.S. government 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. 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:

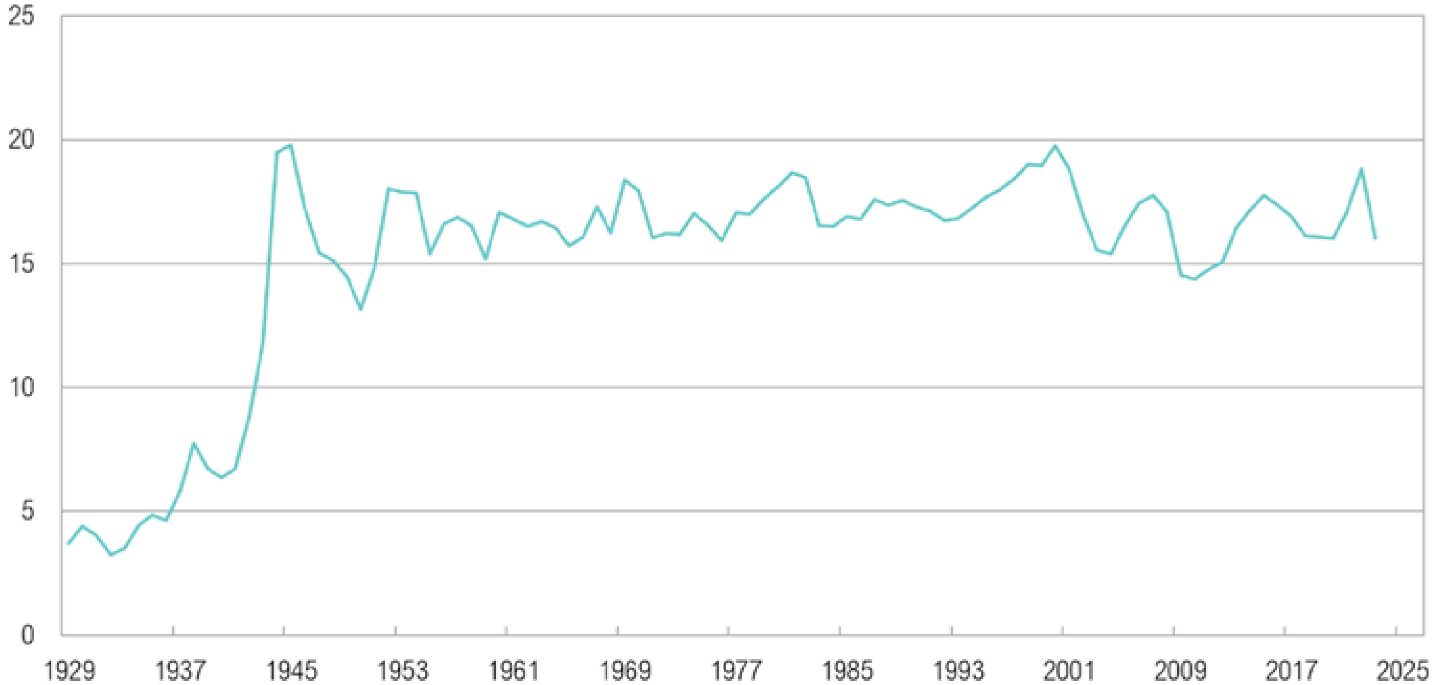
"We do not have a revenue problem in the U.S. We have a spending problem."

In December, Fed Chair Jerome Powell also 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."

Tax Receipts Relative to GDP Have Remained Relatively Steady for Over 50 Years

Federal Tax Receipts as a % of GDP



Source: Bloomberg

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 controversial decisions. For example, it offered a "deferred resignation option," 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. DOGE claims to have saved the government over $100 billion already.

Controversy not withstanding, 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 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. 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.

The same poll also found broad support for placing reciprocal tariffs on countries that have tariffs on U.S. goods. 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. In early March, the temporary pause was lifted, and an additional 10% tariff was added to Chinese goods.

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%. 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, Including notable import gains driven by the movement of gold from Europe to the U.S.

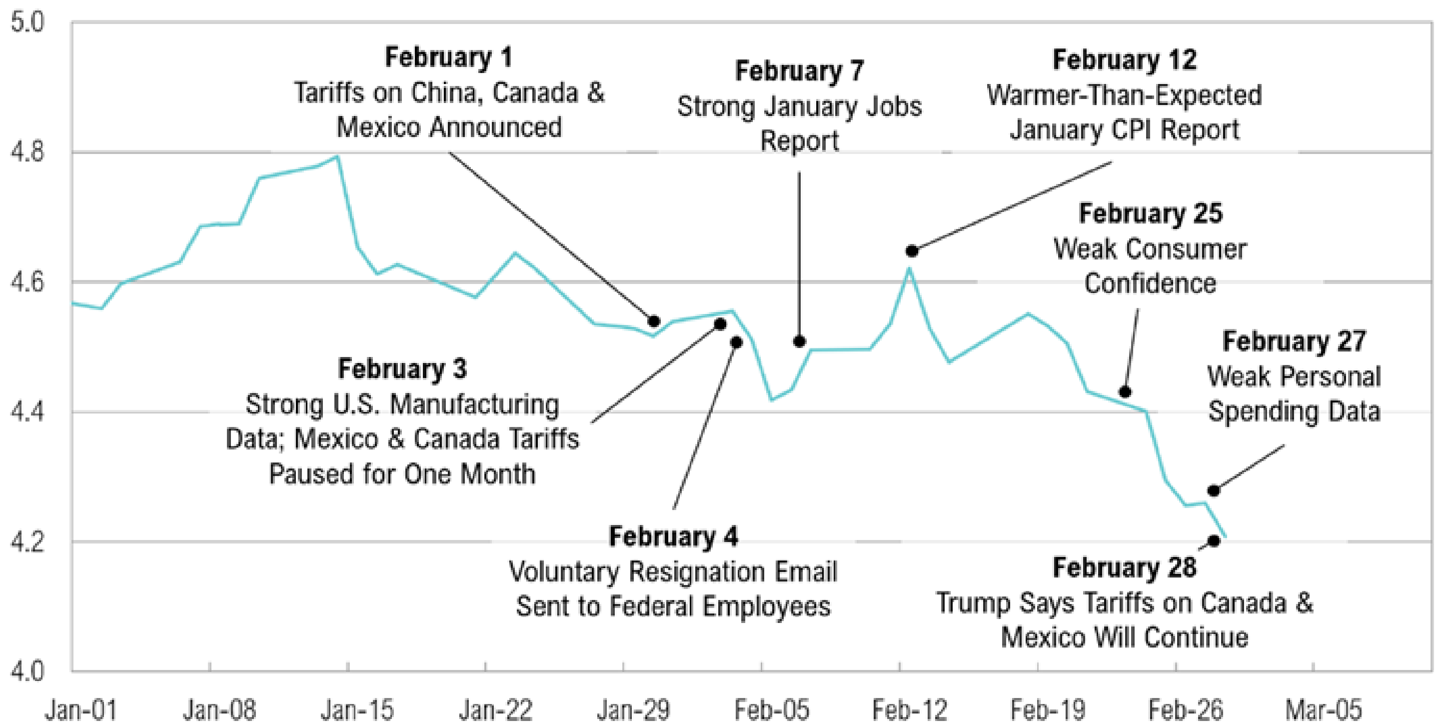
Consumer confidence also dropped by seven points in February, recording the largest monthly decline since August 2021 as pessimism about the future returned. The number of consumers planning a vacation in the next six months plummeted by 6%, the largest monthly drop outside of the COVID-19 pandemic. Reports show that corporate capital spending plans have started to reverse, as uncertainty on the economic outlook grows. 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.

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.

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

Longer-Term Treasury Yields Declined in February

10-Year Treasury Yield, %



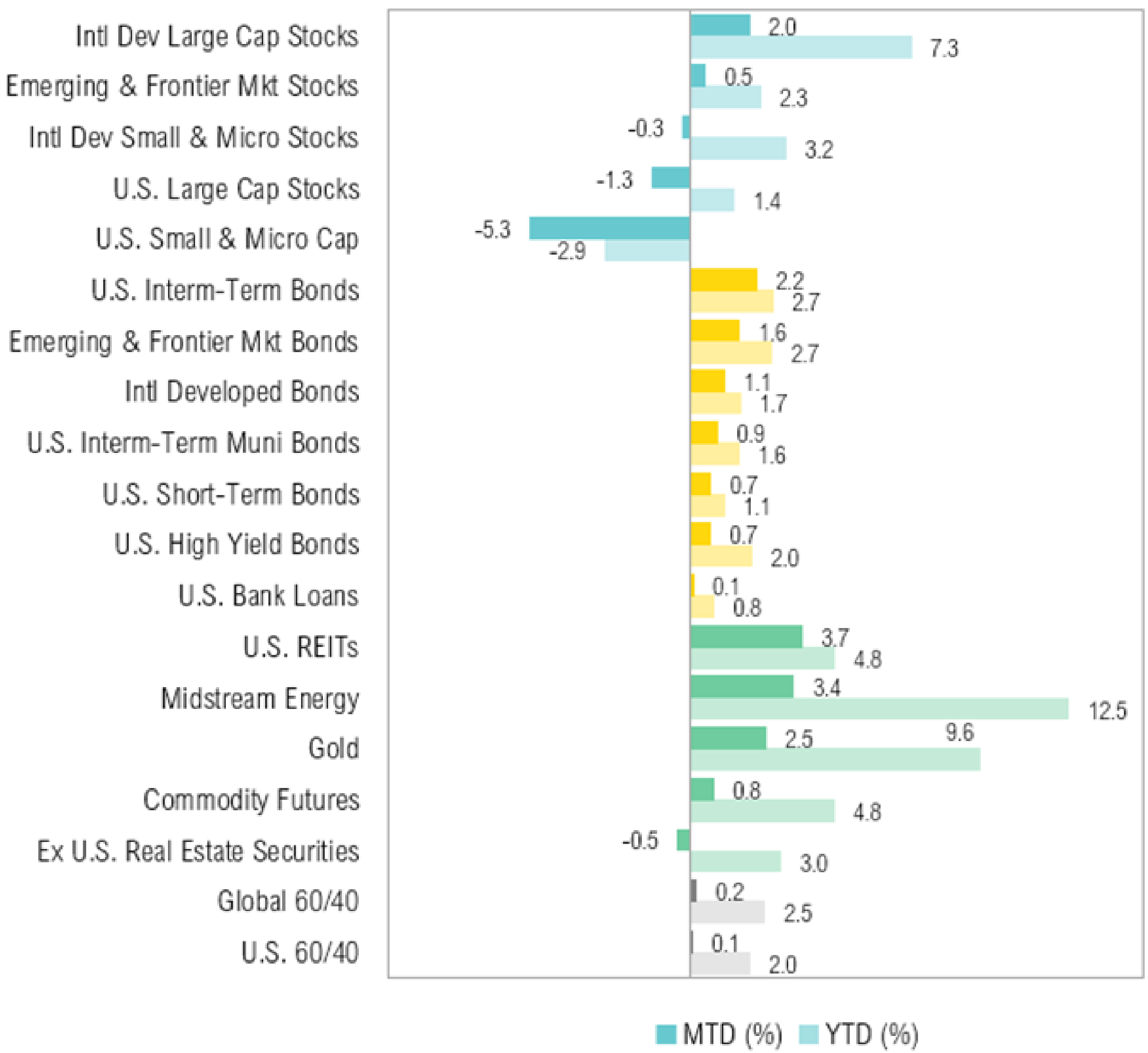
Source: Bloomberg

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%.

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.

February 2025 Key Market Total Returns



Source: Bloomberg

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Looking Forward

The current administration aims to reduce the deficit and 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, overtime, and tips, which would reduce government revenue by $1.8 trillion over the next ten years. Achieving these objectives requires curtailing government spending in the hopes of sustaining the current economic expansion. If markets are satisfied to overlook the short-term pain of deficit cuts and tariff consequences, these strategies may effectively contain broader market disruptions. However, if these efforts falter, the parade may be called off.

As always, if you have any questions or would like to schedule a meeting with one of our investment professionals, please don't hesitate to call us at 508-693-8850.

Sincerely,

Luke Murphy
Managing Director,
Martha's Vineyard Investment Advisors

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Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

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