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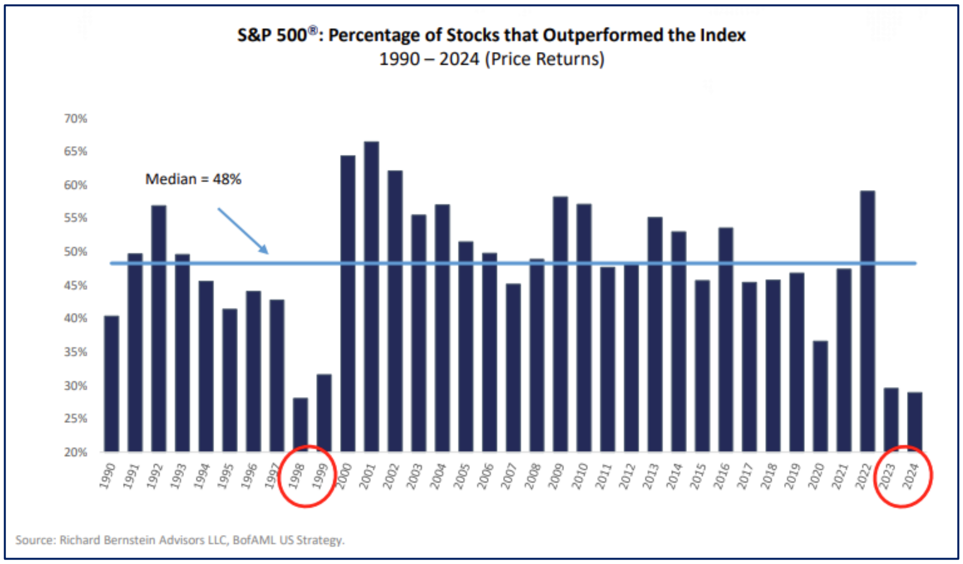
Monthly Update – February 2025

January Review – Market Reversal Highlights the Benefits of Diversification

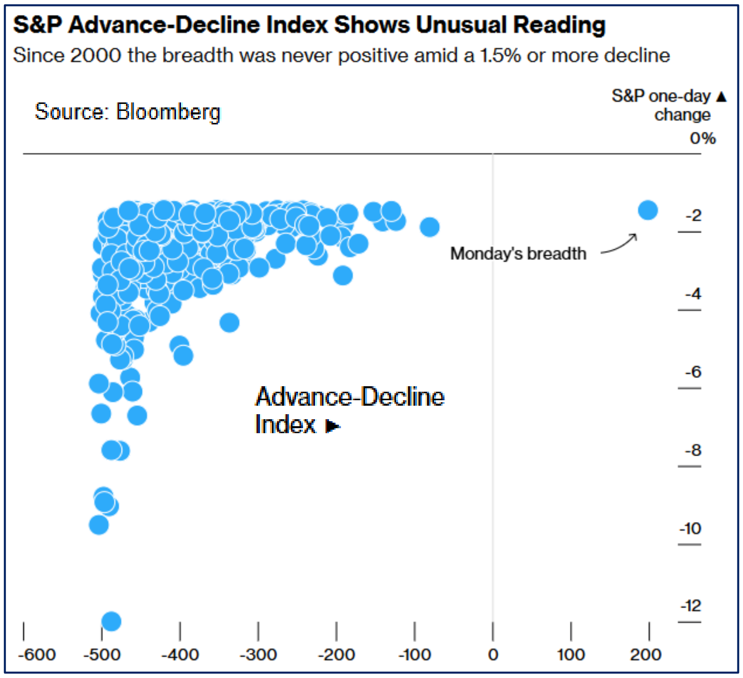


Market performance over the last two years has shared a unique distinction: very few stocks outperformed the index. As the chart at right conveys, we have endured the "narrowest market since the tech bubble"[i]. Results of this nature tend to occur infrequently and the conditions that give rise to such outcomes are just as rare. It is unlikely this feature of the market can persist over a long stretch of time.

The behavior of equity markets during the first month of 2025 would suggest that the abnormal concentration of returns may be giving way to a more normal distribution. Should this trend continue throughout 2025, investors are poised to benefit from an enhanced focus on diversification.

This became quite evident on the last Monday of January. Nvidia's stock price plummeted 17%, erasing $589 billion from its market cap. It was the the day of the "DeepSeek rout"[ii].

While this event was quite damaging to the stock prices of many AI related companies, it did not prove to be negative for most stocks. As depicted in the chart at bottom right, most stocks were positive on the day as 199 more stocks advanced rather than declined in the S&P 500[iii]. It was the onlay since 2000, that the market showed positive breadth amidst a decline of 1.5% or more. This highlights the dichotomy present in the market today and it demonstrates that concentration risk can be alleviated through diversification.



We have highlighted the importance of diversification throughout our conference calls and weekly communications over the last several months and it is also referenced heavily in our recently published Capital Market Assumption White Paper. A review of performance for the month of January enlightens the market reversal that reflects the power of diversification.

January Market Review

Global equity markets delivered a strong month across the board as stocks rebounded from a difficult December.

- Investment grade bonds rose modestly as 10-year yields fell slightly for the month. Better than feared inflation data reversed a rising trend.
- Large cap stocks advanced by roughly 3%, showing a healthy start to 2025. Value surpassed growth.
- Mid-cap stocks fared a touch better, rising by 3.5%. Small caps moved higher by 2.6%.
- International developed markets rebounded more than 4% after a weak 4Q; emerging equities lagged.
- High Yield bonds turned in modest gains on improving risk appetite.

Market Returns Ending 1/31/2025

Category	January	Tr. 3Mo.	1 year
US Stocks			
S&P 500	2.8%	6.2%	26.3%
MSCI US All Cap	3.1%	6.6%	26.3%
Russell Midcap	3.5%	5.2%	19.1%
Russell 2000	2.6%	4.5%	19.1%
International Stocks			
MSCI ACWI ex-US	4.1%	1.2%	11.5%
MSCI EAFE Small Cap	3.5%	1.2%	7.6%
MSCI Emerging Markets	2.0%	-1.7%	15.5%
Bonds			
Bloomberg Aggregate Bond	0.7%	0.1%	2.2%
Bloomberg US High Yield Bond	1.4%	2.1%	9.7%

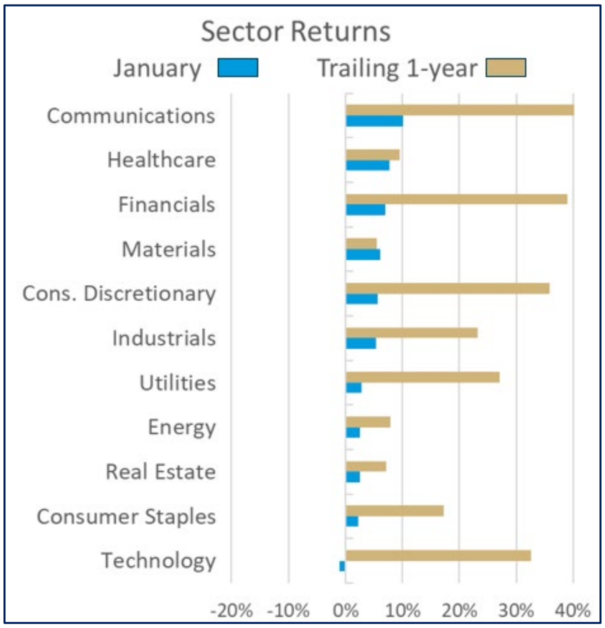
Source: Bloomberg

Category	January	Tr. 3Mo.	1 year
Russell 3000 Growth	2.0%	9.4%	32.2%
Russell 3000 Value	4.5%	3.6%	19.3%

Source: Bloomberg

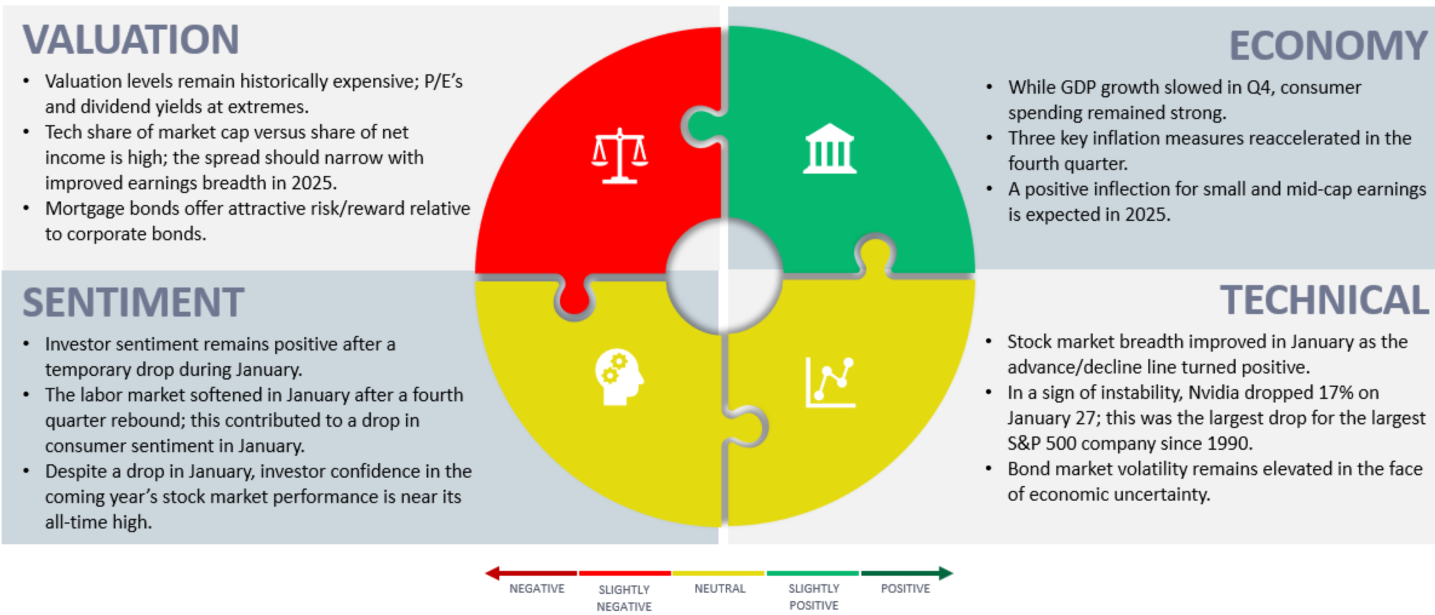
Stock sector movements were consistent with the theme of improved breadth as many sectors reversed their performance from last month.

- Several sectors that underperformed in 2024 and lagged the market in Q4 performed very well: healthcare, materials and industrials.
- Technology stocks turned in a negative return for the month as many investors found themselves too heavily invested and started to realize the significance of the valuation spread between value and growth.
- The “DeepSeek rout” influenced sector performance, but technology was lagging prior to the event.



Our Navigator framework informs us of our outlook.

January 2025 Navigator Outlook:



<u>Economy</u>: Consumer spending remains strong even though GDP growth slowed during the 4th quarter. Inflation is still a risk to the outlook as three key measures reaccelerated in the final quarter of 2024. Earnings estimates look healthy for 2025 and there is a positive inflection expected for small and mid-cap firms.

<u>Technicals</u>: The broad US equity market remains in a positive trend as the advance/decline line turned positive during January. The "DeepSeek rout" that occurred on the last Monday of the month showed a sign of potential risk for extended AI stocks. Nvidia dropped 17% in response. It represented the largest drop for the largest US company since 1990. In addition to equity volatility, bond market volatility remains elevated in the face of economic uncertainty.

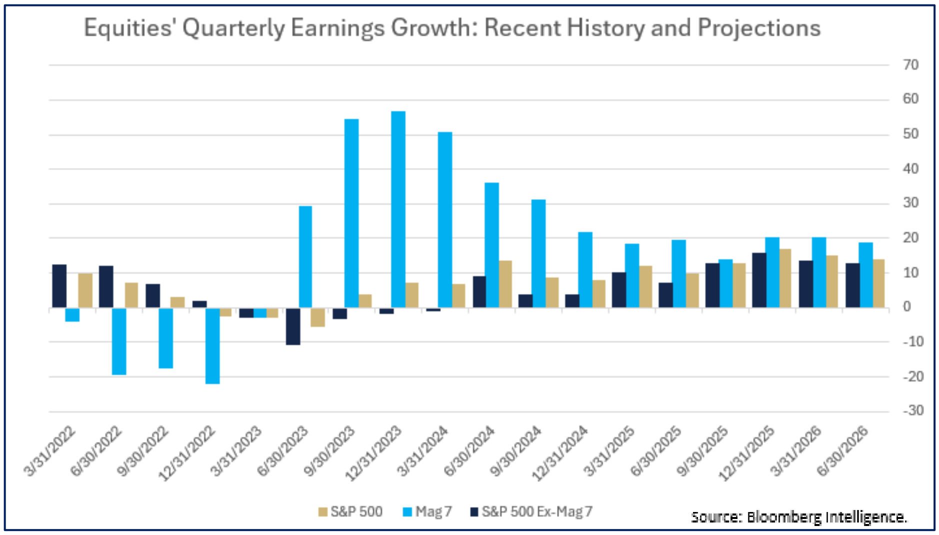
<u>Sentiment</u>: Investor sentiment remains positive after a temporary drop in January. After a 3-month improvement in jobs becoming easier to come by, January saw a move backward. Consumer sentiment took a step backward as well. Despite the mixed signals over the last month, the stock market remains quite close to its all-time high.

<u>Valuation</u>: Valuation levels remain historically expensive for large cap US equities with P/E ratios and dividend yields at extremes. The valuations of small and mid-caps and international equities are more reasonable. Technology's share of market cap in the US far exceeds its share of net income. Given the concentration that tech has established in the market, this represents a risk for returns over coming quarters. The spread should narrow with improved earnings breadth in 2025. Within fixed income, mortgage bonds offer an attractive entry point relative to corporate bonds.

Outlook and Recommendations: Better Earnings Breadth Should Reveal Better Market Breadth

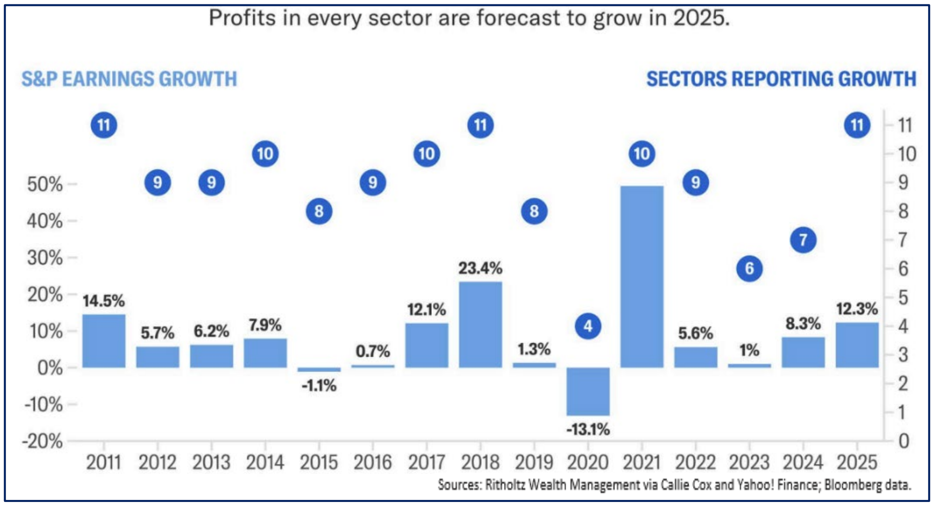
Over the long run, the success of investing in the stock market depends on two key variables: the first is the compound annual growth rate (CAGR) of earnings and the second is the price one must pay for the earnings (valuations). If one assumes that valuations normalize over time and the price of entry and exit is near the long-term average valuation, then long-term returns are going to show a high correlation with earnings growth. In the short term, both earnings and valuations can vary widely across asset classes.

This chart highlights the difference in earnings growth between the Magnificent 7 *(Mag 7 includes Apple, Amazon, Google, Meta, Microsoft, Nvidia and Tesla)* versus the S&P 500 and the S&P 500 *excluding* the Mag-7. While the Mag 7 demonstrated exceptional earnings growth in 2023 and 2024, the outlook for 2025 indicates the breadth of earnings for the rest of the market is improving[iv].



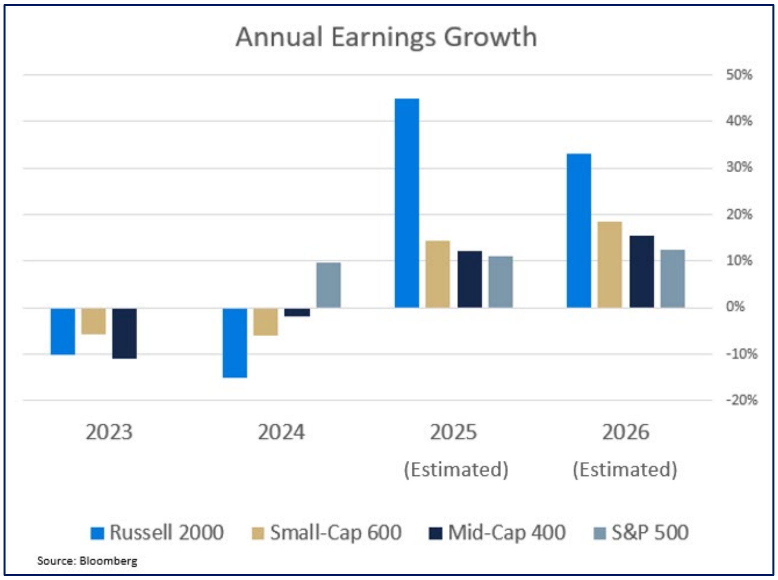
This earnings exhibit does offer some explanation for the concentration of performance discussed at the onset of this note. We believe the difference in fundamentals allowed many investors to ignore the rest of the market to focus solely on the segment with outstanding earnings. As earnings broaden throughout the year, market performance should follow suit.

The exhibit at bottom right offers some additional support. Earnings growth for the S&P 500 is expected to advance at a faster rate in 2025 than it has in any of the past three years and every sector of the market is currently forecast to experience a healthy year of progress on the earnings front. These factors bolster the principle of embracing greater portfolio diversification.



The anticipation of improved breadth for a diversified approach within the S&P 500 focuses primarily on large cap stocks. For the theme of broadening earnings and returns to truly take hold, participation from Small and Mid-Cap stocks would seem to be a prerequisite.

As this chart illustrates, earnings growth expectations for Small and Mid-Caps exceed the expectations of Large Caps for 2025 and 2026. Small and Mid-Cap earnings have lagged Large Cap earnings for the last two years. However, earnings are expected to inflect over the next several quarters for the smaller market cap companies. A return to growth could also contribute to improved valuations for these segments of the market. Small and Mid-Caps may have been easy to ignore the last two years, but improved earnings growth should renew the attention of investors.



These expectations may prove to be a bit too rosy as the market expects earnings to grow by double digits for each of these asset classes in 2025 and 2026[v]. Analysts often have optimistic forecasts early in the year and tend to reduce expectations as the year progresses. It may not be prudent to expect earnings to be as robust as current estimates, but the smaller market cap companies look set to deliver much better relative results.

Risks and Opportunities in the Year Ahead

The case for a broadening of earnings and return dynamics in the equity market can only come to fruition if the economy provides the proper setting. The consumer should continue to spend as long as the employment outlook remains reasonably firm. So, the employment side of the Fed's dual mandate appears to be solid for now. Price stability, on the other side of the mandate, could be at risk if growth surprises to the upside. Persistent inflation could stymie the Fed's flexibility to continue lowering interest rates. Earnings would most likely be strong, but the net effect could lead to higher volatility and lower valuations in equity and bond markets.

Weaker than expected growth could also present challenges, especially if unemployment were to spike. Inflation fears would likely dissipate, and the Fed would have flexibility to cut rates; but consumer spending and earnings would likely suffer material setbacks. These risks are well understood, and they are always present to varying degrees.

It's the risks and opportunities that are newly present with the change in administration that have the market on edge. The current issues with accompanying risks and or opportunities are as follows:

- Tariffs/trade – a modest revenue opportunity and a negotiating tactic, but potential mismanagement that could lead to higher inflation, lower global growth, potential trade wars and extended supply chain disruption is of greater concern.
- Tax cut extension – alleviates some fears of tax increase for businesses and allows for corporate capital expenditures to continue; however, it increases the budget deficit.
- Deregulation – positives for energy production, banking efficiency and M&A activity.
- Government Efficiency – spending cuts that could offset some of the tax cut extension; however, significant spending cuts would likely reduce economic impulse.
- DeepSeek (or other tech development) – any new development that could undermine the current economics supporting the Artificial Intelligence build-out could be problematic. Creative destruction has always been a feature of tech advancements.

Each of these issues has the potential to impact the markets throughout the early years of President Trump's second term as President. The timing and magnitude of implementation remain uncertain, so we should anticipate episodes of increased volatility over the intermediate term.

Portfolio Positioning

Our positioning continues to reflect our long-term focus paired with active risk management:

- While we remain globally diversified, we are shifting equity portfolios to be more US-centric, focused on quality companies with solid cash flows. We are enhancing exposure to areas that are inexpensive and have lagged the market, such as energy and healthcare.
- We retain significant allocations to mid and small caps in the US with lower allocations to large cap stocks. We added to our position in mid-cap value in our tactical sleeve. We have lowered our exposure to growth stocks that may suffer from higher rates and their impact on valuations.
- Our bond portfolios are positioned for steady, and potentially higher, interest rates, with exposure to floating rate high yield debt in our tactical sleeve and higher allocations to corporate and mortgage bonds, with fewer treasuries.

After two years of narrow market performance, we believe it is of paramount importance for investors to focus on diversification and adherence to long-term plans as guiding lights for portfolio construction.

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[i] Source: Richard Bernstein Advisors, LLC.; B of A Merrill Lynch US Strategy.
[ii] Source: Bloomberg story “Nvidia’s $589 Billion DeepSeek Rout Is Largest in Market History”.

[iii] Source: Bloomberg story “Tech’s DeepSeek Slump Left Rest of Market Historically Unscathed”.
[iv] Source: Bloomberg Intelligence.
[v] Source: Earnings estimates collected by Bloomberg.