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Weekly Investment Commentary

Bob Doll, CFA
CEO/CIO

Key takeaways

Equities fell last week (S&P 500 -0.99%) with the tech-heavy NASDAQ an underperformer (-1.63%). AI was the big story of the week, resulting in Monday's NASDAQ sell-off on fears from China's DeepSeek (see #6 below). Outperformers included communication services (2.67%) and consumer staples (1.93%); worst performers were technology (-4.55%) and energy (-3.75%).

Equity markets (Index total return %)	Last week	Year-to-date
DJIA	0.27	4.78
S&P 500	-0.99	2.78
NASDAQ	-1.63	1.66
Russell 1000	-0.40	3.69
Russell 1000 Growth	-1.53	1.98
Russell 1000 Value	-0.13	4.63
Russell 2000	-0.01	3.50

S&P equity sectors (Index total return %)	Last week	Year-to-date
Communication services	2.67	9.12
Consumer discretionary	0.84	4.41
Consumer staples	1.93	2.04
Energy	-3.75	2.07
Financials	1.25	6.56
Heathcare	1.74	6.79
Industrials	-1.90	5.03
Information technology	-4.55	-2.90
Materials	-0.22	5.59
Real estate	-0.32	1.84
Utilities	-2.03	2.93

1. The Fed left the federal funds rate unchanged at 4.25-4.50%, as expected. Fed Chair Powell confirmed that the Fed might pause cutting rates for a while, suggesting that the Fed is in no hurry to resume cuts and that they need to see further progress in lowering inflation.
2. Headline GDP for Q4 missed expectations, coming in at 2.25% vs. 2.6% consensus. The primary drag came from inventories. Underlying data showed strength. (Consumer spending grew 4.2%.)
3. There is evidence (University of Michigan) that consumers are pulling forward some spending ahead of threatened tariffs (and assumed higher prices).
4. All of January's business surveys conducted by five of the 12 regional Federal Reserve Banks strongly suggest that the month's Manufacturing PMI was likely above 50.0 for the first time since early 2022.
5. The 4Q EPS growth ticked slightly lower to +10.4% (down from 14% at the start of the quarter). (EPS growth for financials continues to be the standout as it's now expected to grow at 27.6%.)
6. Chinese firm DeepSeek has taken the evolution of AI to a new level with its cheaper Language Learning Model. This development (if true) disrupts the AI status quo and should speed the proliferation of AI and the realization of associated productivity gains. Last Monday, DeepSeek hit semiconductor and other tech as well as nuclear power stocks. Many of these AI plays dropped by double-digit percentage points, (Nvidia fell 17%, recording the biggest one-day loss ever ($600 billion). The broader market held up fine. The S&P 500 fell less than 1.5%, the Dow rose 0.7%, the CBOE volatility index (VIX) finished the day at a relatively low 18.0, the equal-weighted S&P 500 was flat, and breadth was positive. We continue to think that investors should pay more attention to valuation than usual, that value will outperform growth, and that tech will underperform this year (see 2025 10 Predictions).
7. Even after the sharp sell-off on Monday, the momentum factor remains crowded, suggesting there is ample room for the leadership to continue broadening.
8. S&P 500 correlations have dropped. If that continues and Magnificent 7 has a period of underperformance, active managers should outperform.
9. The underlying catalysts of the bull market have been a resilient U.S. economy, a strong job market, AI-driven productivity gains, and rising investor sentiment post the election.
10. The population of native-born Americans will start shrinking in about a decade, and if immigration slows, economic growth will become challenged.

AI competition and a possible trade war keep things interesting

When a stock is assumed to have a monopoly and enjoys abnormally high profit margins (e.g., Nvidia), then the impact of something that challenges that view can be huge, especially if the stock is priced for near perfection. With the discovery of DeepSeek and the jolt it had on the established AI leaders, we got a taste of that phenomenon. A key question for investors is whether that action will eventually be seen as the peak in the overall equity bull market and start of a lasting de-risking phase, or if it is only just a peak in the stampede to own a handful of highly profitable but very richly priced stocks.

Most critically, the macro backdrop is historically equity-supportive: Monetary conditions are easing after never reaching restrictive territory, and global corporate earnings are in a solid uptrend. Central banks still have an entrenched dovish bias, which is likely being further reinforced by trade war uncertainty. The Magnificent 7 stocks were extremely overbought following their massive outperformance. Thus, they were vulnerable to a setback. The U.S. economy has solid momentum, as confirmed by the Q4 GDP report, which showed that real personal consumption rose 4.2%. It would take sizable contagion from the financial markets to disrupt the expansion. It was instructive that when stocks fell last Monday, the U.S. Treasury market rallied strongly, which reinforces that this important relief valve is still operating. At the end of most equity bull markets, yields keep rising even as stock prices roll over. Moreover, investor behavior during/after that Monday rout was not panicky; rather, a rotation into lagging sectors subsequently occurred, and some non-tech areas even managed to rise.

International equity markets (Index total return %)	Last week	Year-to-date
MSCI ACWI	-0.02	3.79
MSCI ACWI EX U.S.	0.83	4.32
MSCI EAFE	0.94	5.40
MSCI EM	0.53	2.00

Fixed income markets (Index total return %)	Last week	Year-to-date
Bloomberg U.S. Aggregate Bond	0.60	0.69
Bloomberg U.S. Corp High Yield	0.20	1.37
Bloomberg U.S. Gov/Credit	0.55	0.67
Bloomberg U.S. T-Bill 1-3 Month	0.04	0.33

Alternatives (Index total return %)	**Last week**	**Year-to-date**
Real estate (FTSE NAREIT)	-0.07	1.39
Commodities (DJ)	-1.02	3.95
Global listed private equity (Red Rocks)	-0.14	6.73
Currencies (DB Currency Future Harvest)	0.03	0.24

As with all central banks, the Fed must now contend with the potential for a broad and possibly large global trade war. Will tariffs be large enough to trigger higher inflation and, ultimately, weaker global growth? If so, we anticipate that the Fed et al. will ignore a period of higher consumer inflation if they fear that economic activity will weaken meaningfully. If the economic impact does not seem likely to be significant, central banks will face the challenge of whether to tighten policy due to tariff-induced increases in consumer prices, or do nothing and gamble that economic growth will eventually soften. For now, there is no clarity on what specific trade actions will occur, nor for how long. Thus, it is premature to make aggressive bets on possible outcomes.

Normally, tightening monetary policy is the cause of bear markets in risk assets and economic recessions. Perhaps, for the first time in the post-WWII period, trade policy will be that catalyst. For now, we are assuming Trump will not take the risk of undermining the U.S. economy, not to mention contributing to an equity bear market.

Conclusion

The prospect of meaningful trade tariffs hangs over asset markets and is likely impacting central bank thinking inside and outside the U.S. A major global trade war is not discounted in asset prices, but we remain hopeful that something well short of such an outcome will occur. Meanwhile, fourth-quarter earnings reports are buoying markets.

Source: Bloomberg as of Jan. 31, 2025