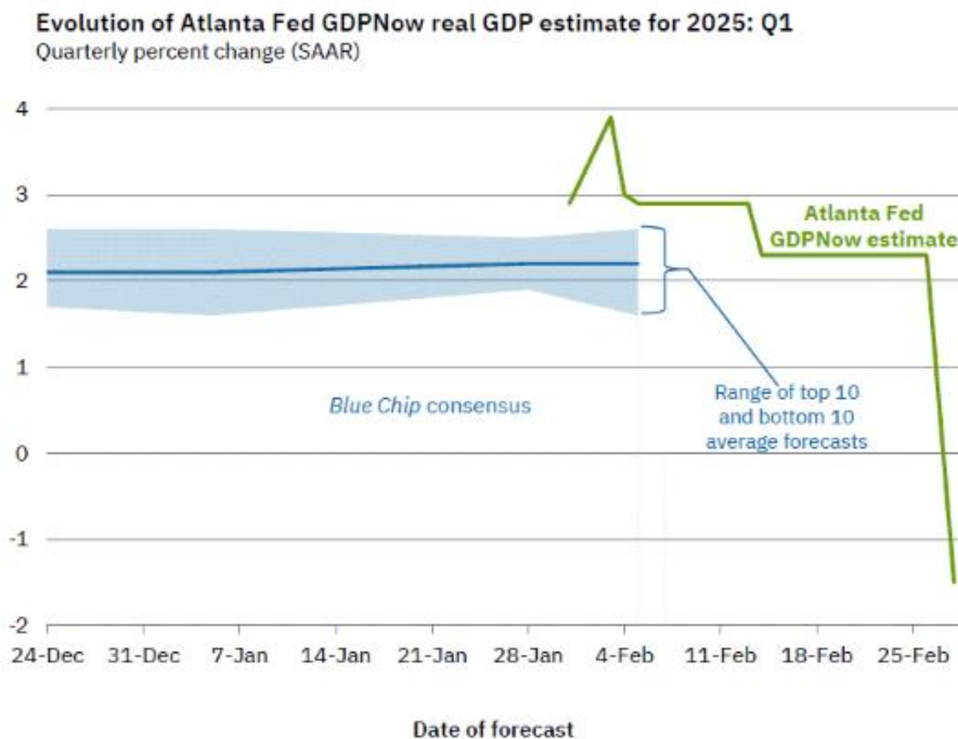
UBS

2/28/2025

Market Commentary from Shaun Rowles | The Rowles Report

Growth Scare or Growth Slowdown?

Sometimes a picture is worth a thousand words. To set the stage for this commentary, let us examine the latest output from the Atlanta Federal Reserve's GDPNow model which I believe summarizes the late February market movements perfectly.



As of this writing, the S&P 500 and the Nasdaq indices are negative for 2025. This is a sharp turn of events following a reasonably enthusiastic January in which the indices enjoyed a positive return north of 2% despite a notable weakness in the "Magnificent 7"(the cohort of 7 tech stocks that have powered indices higher for the past two years).

A question for investors now becomes: is this a turning point, or just normal market business?

In this edition of the Rowles Report, I will cover a list of observations that do in fact mark our current scenario as "unique". We will examine the very real adjustments occurring in the underlying economy and take a look at what the data suggests could be in store. We will discuss earnings, valuations, investor sentiment and behavior, housing, inflation, and employment.

Short on time, allow me to paraphrase by data-driven outlook: "not yet, but getting closer". I remain positive towards equities, but believe there is a need for increased diversification to other asset classes and am watching risk management tools closely, with an eye towards hedging. Want to hear more, then please read on.

Sentiment Turns Decidedly Sour

The final week of February 2025 enjoyed a very rare reading of negative sentiment as measured by the American Association of Individual Investors (AAII). This survey has offered weekly updates on the sentiments of individual investors since 1987.

The February 27th 2025 reading indicated 60.60% Bearish Sentiment, which historically ranks as the 7th highest reading in the survey's history. This level of a negative sentiment reading places the survey result in a rare group of prior signals, joining August & October 1990, October 2008, March 2009, and September 2022.

Perhaps the most interesting thing about this reading is that in all prior instances of extreme negative sentiment, the equity markets were at or near their "bear market" lows, typically down in excess of -25%. Yet this week's reading occurred when the S&P 500 was only 3% off of an All-Time High!

This is not the only survey that has turned notably concerned in recent weeks. The Conference Board released the Consumer Confidence Index update on February 25th, 2025 with notable declines : "In February, consumer confidence registered the largest monthly decline since August 2021" (Stephanie Guichard, Senior Economist, Global Indicators at The Conference Board 2/25/25).

This marked the third consecutive month of declines and coincided with the University of Michigan's February gauge of inflation expectations which rose to 4.3% inflation expected over the coming year, and 3.5% over the next five years (University of Michigan 2/21/25).

So what do we make of it?

Longtime readers of the Rowles Report should have no surprises with respect to the path of inflation. We have discussed at length that based on my preferred inflation model, expectations were for a rise in inflation at the end of 2024 that would linger into early 2025. This is what has, in fact, played out.

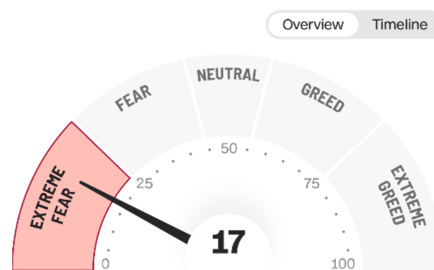
But, my expectations for inflation readings should soften over the coming months. With today's 2/28/2025 release of the Personal Consumption Expenditures Price Index we noted a 2.5% year-over-year increase (Bureau of Economic Analysis 2/28/25). This reading returns to the level last seen in November 2024, and clearly exhibiting a trend of inflation increasing into the end of the year and then beginning to soften (exactly as our playbook suggested).

I expect that, as often is the case, sentiment and consumer expectation survey's reflect anxiety around uncooperative data and an increased sense of uncertainty for the future. This is why such readings tend to occur at an apex, or inflection point for markets. For the contrarian investor, highly negative readings are interpreted to suggest "buy" signals rather than "sell" signals. So it is worth noting the above sentiment gauges have occurred when the CNN "Fear & Greed" Index is reading "extreme fear".

Fear & Greed Index

What emotion is driving the market now?

Learn more about the index



CNN Fear & Greed 2/28/2025

So, this is good news, right?

It's complicated.

Softening inflation data into mid-year may help consumers and perhaps more importantly assist in credibility for the Fed's 2024 policy rate cuts. But there is a risk that comes along with this that should not be overlooked. Before examining that risk, let us first look to some of the other data points within the economy.

Earnings

The bulk of "earnings season" has now concluded and we get a good look at how the fourth quarter of 2024 shaped up. According to Jurrien Timmer at Fidelity, Q4 2024 earnings grew at 13% year-over-year (Fidelity Weekly Asset Allocation Review 2/28/2025). This was above expectations, with the bulk of companies clearing their hurdles. But, the market behavior in response was different this time around. Smaller companies that had strong beats were significantly rewarded, while the large companies who beat were largely ignored or discounted. Mega-cap tech (the Mag 7 in particular) showcased this most visibly.

What is happening?

Fidelity's Jurrien Timmer suggests that "with 2025 estimates coming down, it looks like the peak is in for the earnings growth cycle" (Fidelity Weekly Asset Allocation Review 2/28/25). In the chart below, Jurrien stacks the earnings estimate progression for 2013 to 2026 and notes that 2025 earnings have slipped to 10%.

Fidelity Weekly Asset Allocation Review 2/28/2025

S&P Global's Howard Silverblatt has begun trimming his earnings expectations modestly down from $271.25 as of 12/31/24, to $268.05 as of February 18th 2025, or a 15% estimated increase y-o-y (S&P Global S&P 500 EPS estimates, Howard Silverblatt 2/18/25).

At February month end S&P 500 price level of 5,861, the S&P 500 is trading at 21 times forward earnings of $268.05 for 2025. This is clearly expensive from a historical perspective. But we knew that, right?

Valuation

Longtime readers are not surprised by the continued description of US equities as "over-valued". There are a wide array of explanations for this phenomenon, with one of which coming under recent scrutiny : US exceptionalism.

The idea holds that due to the exceptional innovation and profitability of a litany of key US businesses, our domestic market carries a premium in both growth and earnings quality. Indeed, US markets have outperformed the rest of the world (ROW) for an unusually long time period. That was, of course, until this year.

There was an almost subtle uptick in performance from a number of international markets occurring this year, with some surprising backdrops of weak fundamental economies such as Germany. But it was a report out of China that really seemed to wake everyone up to what is occurring.

In late January, a Chinese company called Deepseek made global headlines with a record breaking artificial intelligence model. This quickly sent US mega cap tech companies into a sharp selloff, not because of the model, but because of the narrative of how Deepseek created their model in a short time period, with limited reported resources. This was considered a game changer.

Implications for the AI market aside, this headline report served as a catalyst for observers to note the sudden renaissance in international opportunities. As of this writing, there are a large number of international equity indices that are outperforming the US by a healthy margin.

Indeed, the Global Dow Index as compiled by All Star Charts, and encompasses the US, Japanese, and major European indices is at new all-time-highs.

This begs the question, is it finally time to diversify out of the US?

Many investors have asked this question annually for almost a decade now, and each year have been sorely disappointed. But this time could be different. There is no doubt that valuations are substantially more attractive in many of the overseas markets and given the new administration in the US, an argument can certainly be made that policies could impact the US investment thesis.

My thesis, if you have not already begun to consider diversification, it may be time to do so, especially if the dollar begins to weaken.

But for those whose assets are predominantly invested in the US, is the current valuation level an issue? There are a large number of studies circulating in the marketplace that indicate that the US is positioned for weaker levels of growth over the coming decade based on current valuations. I, myself, have studied this at length and keep a close eye on interest rate and inflation adjusted fair value relative to history. I can comfortably state that the US is overvalued.

But does that mean un-investable?

I have referenced the mega cap technology stocks a number of times in this writing. Although they appear to be in a near-term malaise as investors "lock in profits, and rotate to other assets", they remain a huge component of the broad market indices. Given this large role, one could make an argument that our market, and indeed our economy, is a very different creature (structurally speaking) than it was just a few decades ago. If one were to approach the S&P 500 as having transformed more into a large growth technology dominant index, then valuations would need to account for this, no?

According to analysis by Guru Focus, the median 10-year P/E for their preferred Technology Sector index is 25.01, with a 10-year range of 17.8 to 37.69 (3/1/2025 Guru Focus). Technology stocks are understood to have higher P/E ratios than other sectors due largely to their higher earnings growth capacity. If we are shifting increasingly towards a technology led economy, then it stands to reason that the P/E for the S&P 500 could experience a modest drift higher than the historical average.

This is in no way a justification to ignore valuations, but instead a reminder that there are structural adjustments occurring under the surface and perhaps account for part of the adage "the market can stay irrational longer than you and I can stay solvent".

This is not to say that I am not concerned by current valuations. I monitor this closely and continue to expect a much needed adjustment to prices in our future…but maybe not just yet.

Anxiety on Thursday February 27th 2025 and most of the day Friday the 28th swirled around the idea that we may be beginning a formal correction, that could potentially lead to another "bear" market, and perhaps even a recession. While this is always a persistent anxiety and threat to equity investors, I do not think this is the "big one". At least, not yet.

In addition to the Global Dow Index making new all-time highs this week, the STOXX Europe 600 Index SXXP also made new highs. Not to miss the party, Berkshire Hathaway made a new all-time high, as well as both the US Financials (XLF) and the European Financials Index (EUFN). It is challenging to rationalize imminent doom with fairly meaningful components of the economy powering higher.

Almost as if to prove my point for me, the S&P 500 enjoyed a strong move higher into the close on Friday February 28th 2025, breaking a month long trend of selling off every Friday as investors opted to trim risk before each weekends potential news flow.

From a technical point of view, prices appeared to behave well and the current upward channel for the S&P 500 remains intact.

TrendSpider Published 2/27/2025

So should we be worried?

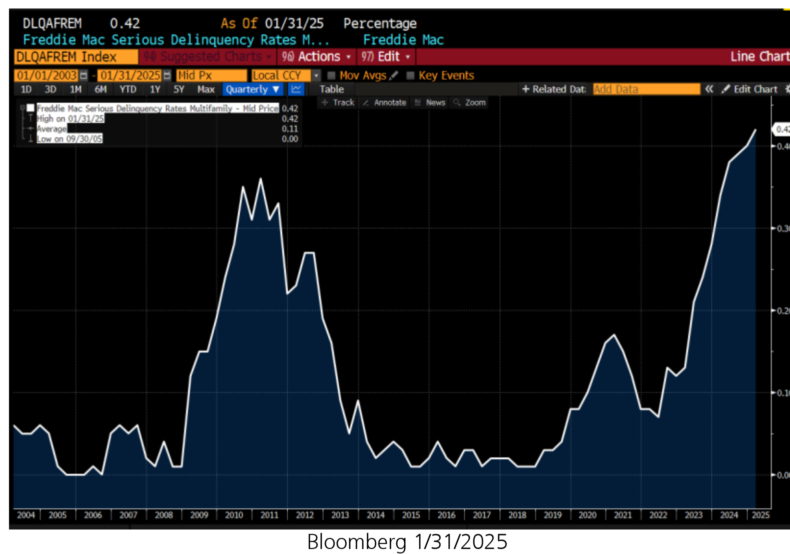
Absolutely. There are a wide array of items facing both the domestic and global economy that have our direct attention.

Real Estate

The US housing market continues to be in a deep freeze. The US Pending Home Sales Index has fallen to the lows of this century. Rates continue to deter some buyers, while prices continue to sideline another cross section of would be home owners.

Bloomberg 2/27/25

Within the existing home loan market, we appear to be seeing increased delinquency rates. This comes on the heels of other data points suggesting the consumer may finally be under strain. Below we see the rise in delinquency rates for multi-family which has surpassed the levels seen in the Great Financial Crisis. Something to watch indeed.



Bloomberg 1/31/2025

This brings us to an interesting point, when we talk about the consumer…which consumer are we talking about? On September 14th 2020, I released a market commentary entitled "The Calendar & the Alphabet", in which I discussed a "K-shaped" recovery out of Covid. This K-shaped description referred two a dual track of recovery for two distinct cohorts of the US consumer.

Recent reports indicate that the top 10% of the US population account for roughly half of all US consumer spending, which is up from 36% three decades ago (WSJ & Moody's Analytics 2/23/25). Ritholtz Wealth Management, added to this picture noting on CNBC February 23rd, 2025 that this same top 10% own 67.3% of Total Wealth, 87.2% of Stocks, 84.4% of Private Businesses, and 43.9% of Real Estate (CNBC 2/23/2025).

When we are discussing the US economy, we are having a bifurcated conversation. This is why data points can be pointing in two different directions at the same time. As market participants, we must be attentive to this fact in forming our views. From a macro perspective, this level of disparity makes policy even more challenging than normal. It is to this topic that we will turn next.

So It Begins…

I have been worried for some time about a potential change in narrative. One that, I believe, is potentially bad for investors while perhaps positive for the country. I am once again referring to *financial repression*, a condition in which policy rates are brought and held below the inflation rate, which in turn slowly erodes away debt-to-GDP through inflation, or the invisible tax.

On the February 27th 2025 edition of CNBC's Closing Bell, Ankur Crawford, Executive VP & Portfolio Manager for Alger, stated:
"I do think the Fed needs to re-think the 2% inflation target rate and they are not going to make a policy error if they rethink it to 3% because we are structurally going to have higher inflation in this country until we get the benefits of AI and all the technology" (CNBC Closing Bell 2/27/25 2:21pm).

We have discussed the dangers to investors of a condition of financial repression as well as the potential benefits to the country's balance sheet. What has been more challenging is defining the characteristics of how we may get there.

I have noted repeatedly that the inflation gauges I monitor appear to suggest a lingering long-term inflation rate above 3%. Given the Fed's clear attention to inflation, it is more challenging to anticipate cutting policy rates despite a persistent lack of reaching the 2% target. Indeed, my December commentary applauded the Fed moving to the sidelines and the market's subsequent pricing out of any additional rate cuts for 2025. But as of the end of February, 2-3 rate cuts have been priced back into the market. To me, this is a problem.

2025 is setting up to be a year of transition for the Fed. One in which they shift their attention from inflation to employment. We are already off to a very heavy flow of reductions in force from the private sector. But this may be dwarfed by the reductions in government headcounts. If the unemployment locomotive gets rolling, the Fed may be forced to cut policy rates despite where inflation lingers.

As stated earlier, the inflation models I prefer seem to suggest favorable inflation readings from now into mid-year before moving higher again. I fear this will offer a data path that accommodates the Fed cutting mid-year, as the market currently expects. This would be a risk-off trigger for me.

I understand a number of parties in the US and globally are rooting for additional rate cuts. From my perspective however, this would be a bad sign.

But AI?

The second half of Ankur Crawford's quote on CNBC was "until we get the benefits of AI". This necessarily leads us to discuss the latest in the new technological revolution, or AI arms race. The news from China's Deepseek in no way slowed the freight train of artificial intelligence. In fact, shortly after the news broke, the mega-cap US tech companies re-confirmed their intentions to spend billions on additional infrastructure. Not to mention, continued discussions around required energy infrastructure investment just to maintain our current trajectory, let alone get ahead.

So money is still flowing in, but is it flowing out? Monetizing AI continues to be a somewhat challenging subject. After essentially two years of heavy investment, there are few stories of nosebleed return-on-investment (ROI). To be sure there are some companies that have made more progress than others, and their stock prices seemed to reflect this. But in terms of a "great leap forward", to borrow a disturbing phrase from history, we have yet to see it materialize. This has led some investors to question what can we really be expecting from all of this "investment"? Or are we building a dramatic oversupply of low yielding technological tools and infrastructure?

To frame this question appropriately, we must remember that in the world of technology little happens in 2 years, but a lot happens in 10. It remains to be seen if AI will deliver the great productivity boost that economists are looking for, or the great deflation/dis-inflation that Ankur Crawford seems to be expecting.

But there is one area in which AI will dramatically add value, and perhaps already is: the surveillance economy. In his book "Life After Google: The Fall of Big Data and the Rise of the Blockchain Economy", author and technologist George Gilder used a phrase "surveillance capitalism", (a phrase coined by Harvard Professor Shoshana Zuboff) to describe the revenue generation machine inside of some of the largest technology companies. Using big data collected on users of their platforms, companies could monetize a superior form of marketing & advertising to drive outsized profits. Over time, better marketing may give way to behavior modification as the next frontier in driving spending.

It remains to be seen if AI will successfully replace large cross sections of the employed human population, but one thing it is already good at is analyzing big data sets, quickly understanding human behavioral tendencies, and optimizing user engagement. Layer in greater data sets, such as facial recognition and iris scanning, the surveillance economy could quickly get a substantial boost to already powerful revenue streams.

I discuss this topic to suggest that while many are waiting for paradigm shifting new revenue streams or cost compressions, some of the most powerful revenue generation strategies this century just got a massive dose of steroids.

Sometimes we do not need to reinvent the wheel to be profitable.

Putting it all together

I led this commentary with the eye-catching drop in projected GDP from the Atlanta Fed. This chart has gone viral in an era of social media that appears to get enhanced engagement around negative news. Economist Paul Winghart points out that an often overlooked report appears to have been the culprit for the sharp decline, the Advanced International Trade data, which in the most recent report produced "some absolutely abnormal results; results otherwise unattainable if it weren't for the possibility of tariffs hanging over the U.S. economy's head" (Paul WInghart Surplus Productivity "GDPNow, Now: Tariff Front Running Behind Big Drop" 2/28/25).

Just like the Fed, it is important that we refrain from relying on a single data point. The GDPNow model updates in real time as data is released. It would not be surprising to see a sudden sharp move higher in due time. But for now, this large negative report happened to be released during a typically weak period for equity markets. Perhaps in the fullness of time,

we will look back to this report as a warning shot. One in which our eyes are opened, policy is adjusted, and we avoid negative outcomes. Or one in which, we continue on unabated only to deal with a bigger mess later…only time will tell.

While I believe the current market volatility is normal seasonal weakness and have not yet had any significant risk-off triggers, I do believe we are approaching a more challenging period in which the Fed's policy hand may be forced. Should this occur, it is most likely to happen in the summer months and could have lasting effects on both equity and fixed income markets.

Should March and April bring a rebound in equities and yields, investors may benefit from adjusting risk exposures and beginning to diversify beyond the more narrow band of what has worked over the past two years. Keep calm, carry on, and stay frosty!

As always, I hope you have found this both enjoyable and helpful.

Kindest regards,

Shaun Rowles
Senior Vice President – Wealth Management
Financial Advisor
Portfolio Manager
Institutional Consultant
UBS Financial Services Inc.
6100 Tower Circle Suite 100
Franklin, TN 37067
Tel: 615-721-4909
Cell: 865-803-3453
shaun.rowles@ubs.com

www.ubs.com/team/ewp

The information in this material has been prepared by, and reflects the opinions and various investment views of, the author. UBS Financial Services Inc. has not independently verified such information and does not guarantee its accuracy or completeness. This information is being provided to you for your information purposes only and does not constitute a recommendation or an endorsement by UBS Financial Services Inc. of the author, the securities or views stated herein. Any specific securities discussed should not be considered a recommendation or solicitation to buy or sell any particular security. You should not assume that any investment in any of the securities was or will be profitable. The information contained in this material is not a solicitation to purchase or sell investments. Any information presented is general in nature and not intended to provide individually tailored investment advice. Investing involves risks and there is always the potential of losing money when you invest. Two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. **Furthermore, high yield bonds are considered to be speculative with respect to the payment of interest and the return of principal and involve greater risks that higher grade issues..** There are special risks associated with an investment in real estate, including liquidity risk, credit risk, interest rate fluctuations and the impact of varied economic conditions. The technology industries can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants, and general economic conditions.

Neither UBS Financial Services Inc. nor its employees (including its Financial Advisors) provide tax or legal advice. You should consult with your legal counsel and/or your accountant or tax professional regarding the legal or tax implications of a particular suggestion, strategy or investment, including any estate planning strategies, before you invest or implement.

UBS Financial Services Inc. is not affiliated with the third parties mentioned.

Past performance does not guarantee future results.

The past performance of an index is not a guarantee of future results. Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. Indices are not actively managed and investors cannot invest directly in the indices.

As a firm providing wealth management services to clients, UBS Financial Services Inc. offers investment advisory services in its capacity as an SEC-registered investment adviser and brokerage services in its capacity as an SEC-registered broker-dealer. Investment advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate arrangements. It is important that you understand the ways in which we conduct business, and that you carefully read the agreements and disclosures that we provide to you about the products or services we offer. For more information, please review client relationship summary provided at **ubs.com/relationshipsummary**, or ask your UBS Financial Advisor for a copy.

©UBS 2025. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS Group AG. Member FINRA/SIPC. Expiration: 3/31/2026 IS2500314