MARCH 2025

NEW YEAR, NEW MARKETS: ADAPTING TO SHIFTING TRENDS

Executive Summary

- We are at an interesting juncture for the markets. Equity and credit markets are not discounting the potentially negative impacts of key components of President Trump's agenda. Rather, markets are focused on current fundamentals, which remain sound, with an optimistic eye towards what deregulation and tax-cut extensions might mean for corporate earnings and consumer spending.
- Concerns about economic growth have been rekindled by falling consumer confidence, as households anticipate declining affordability and softening labor market conditions due to tariffs and trade uncertainty. This has caused the slide in Treasury yields to intensify, with the 10-year rate now at 4.3%.
- Ongoing punitive and retaliatory tariffs and tariff threats should support the U.S. Dollar, but they're also likely to create more frequent bouts of market volatility and stoke uncertainty about the Fed's next actions.
- While businesses are signaling uncertainty about the path forward for trade and immigration, they are buoyed by expectations for deregulation and solid fundamentals and are expressing cautious optimism about the outlook for revenue and earnings growth this year.
- Looking ahead, our view is that this tension between healthy fundamentals and rising risks is likely to keep investors cautiously optimistic while limiting the extent to which already elevated valuations expand further.

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Diversified portfolios are off to a positive start this year, but volatility has picked up over the past few weeks as investor confidence has been tested by growing policy and economic uncertainty. Therefore, the trends underpinning market performance year-to-date (YTD) have shifted relative to last year. Investors are positioning their portfolios to balance the reality of still resilient fundamentals (S&P 500 earnings per share [EPS] grew ~12% year-over-year [YoY] in Q4 24) with the risks associated with growing uncertainty. As a result, in the equities market, cheaper international developed stocks are outperforming the more expensive U.S. stock market. Also, unlike last year, Large Cap Value is outperforming Large Cap Growth. The Russell 1000 Value Index has gained nearly 4.4% YTD, outperforming its Growth counterpart by nearly five percentage points. Small Cap stocks, meanwhile, are down ~2.5% YTD, underperforming their Large Cap peers. In fixed income, the Bloomberg Aggregate Bond Index is up 2.3% YTD, while high-yield bonds have underperformed (up 1.9% YTD).

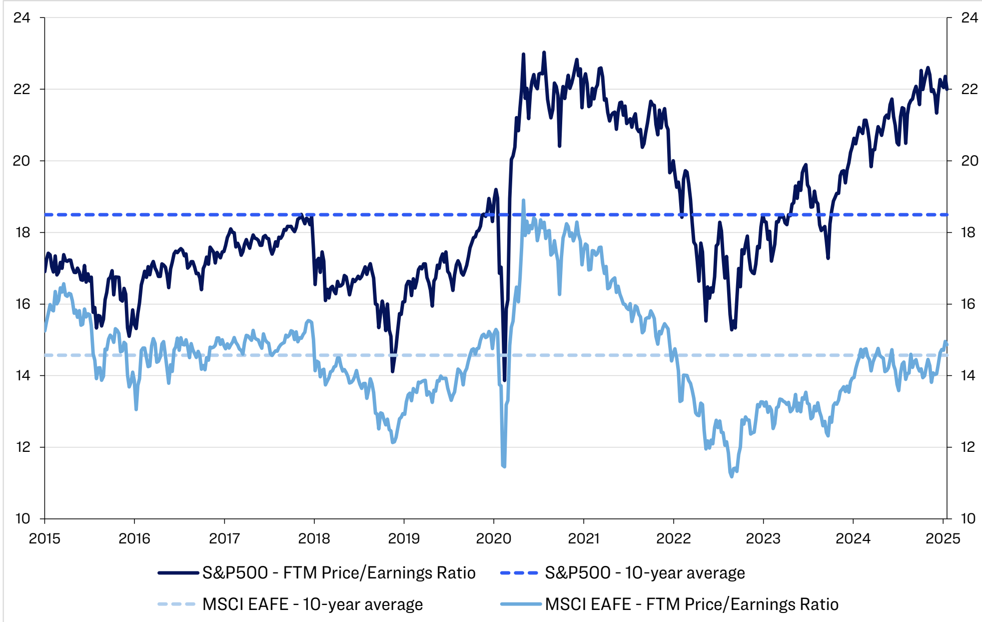
Most asset classes remain expensive[1] relative to their price history—a dynamic we explored in our 2025 Outlook.

- The investment-grade corporate spread—the extra yield provided by investment-grade corporate bonds over Treasury bonds—stands at 82 basis points vs. a 10-year average of 121.
- High-yield bond spreads stand at 277 basis points vs. the 10-year average of 414.
- The forward 12 months (FTM) price-to-earnings ratio (P/E)—which measures how much investors are paying for a company's next 12 months of earnings—now averages 22x for the S&P 500 vs. a 10-year average of 18x and a long-term average of 16x (Figure 1).
- The FTM P/E ratio for developed international and emerging market equities is not quite as rich—15x and 12x, respectively, vs. the 10-year average of 14x and 12x.

1 As of February 26, 2025.

FIGURE 1

Forward 12 months price-to-earnings ratios (P/E) show U.S. stocks are currently well above their 10-year average while developed international stocks are in line with their 10-year average.



Source: Bloomberg, TIAA Wealth CIO. Data through 2/21/2025.

We are at an interesting juncture for the markets. Equity and credit markets are not discounting the potentially negative impacts of key components of President Trump's agenda. Rather, markets are focused on current fundamentals, which remain sound, with an optimistic eye towards what deregulation and tax-cut extensions might mean for corporate earnings and consumer spending. So long as the fundamentals stay on solid footing, higher valuations can be supported. However, there is no doubt that risks to the markets have increased with news of both novel and retaliatory tariffs, DeepSeek's artificial intelligence (AI) development, and indications that the Federal Reserve (Fed) is inclined to pause its interest rate cutting cycle while assessing the impact of trade and immigration policies, therefore leaving monetary conditions more restrictive than initially anticipated.

As the environment continues to evolve, there are a few trends we are focused on:

1. **Policy uncertainty out of Washington is growing.**

   President Trump's policy sequencing—and the severity of the related impacts—are critical to our investment outlook in 2025 and 2026. President Trump began his second term with a flurry of executive actions, many of which caught the world off guard. For instance, the threat (and imposition) of tariffs came quicker than many investors initially expected. The global trade landscape remains in a state of flux. Though tariffs on Mexico and Canada were avoided—at least for now—the U.S. did increase tariffs on Chinese imports in mid-February. Tariffs on China and several European nations could continue to climb higher over time. This would be consistent with the administration's "America First" trade policy, designed to reduce the trade deficit in goods, bolster national security, protect key technologies, and re-shore supply chains.

   Ongoing punitive and retaliatory tariffs and tariff threats should support the U.S. Dollar (USD), but they're also likely to create more frequent bouts of market volatility and stoke uncertainty about the Fed's next actions.

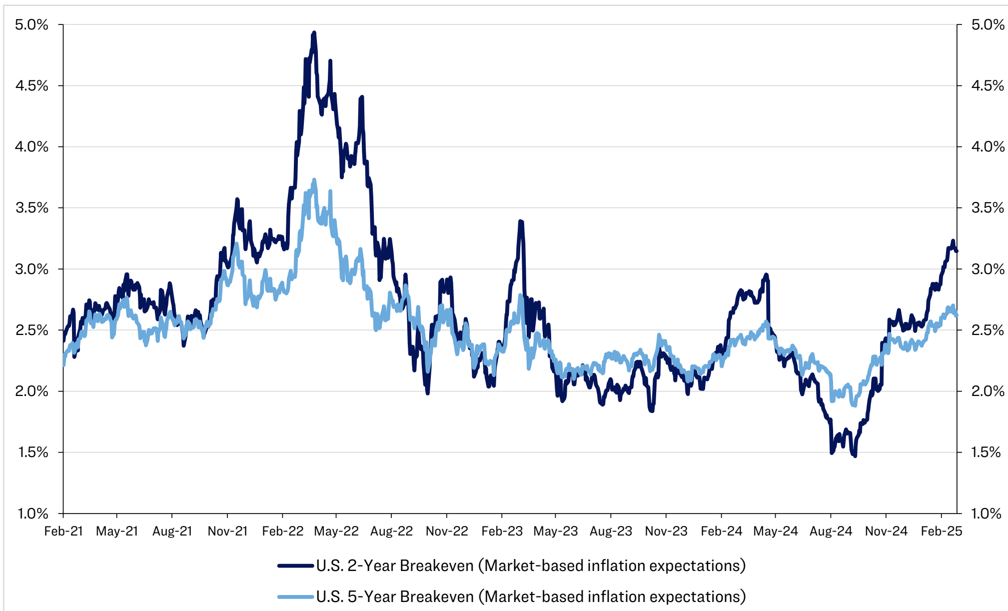
2. Inflation expectations are rising.

Two-year and 5-year breakeven inflation rates—a metric predicting future inflation in coming years—have marched higher thus far in 2025, though the 5-year breakeven rate is still in line with long-term averages (Figure 2). Consumer expectations for inflation have risen, likely due to tariff news. The University of Michigan Consumer Sentiment Index for one-year inflation expectations rose to 4.3% in February, up from 3.3% in the prior month, and 5- to 10-year inflation expectations jumped to 3.5%—the highest since 1995.

Inflation expectations have always been central to the Fed's decision-making process; in 2018, Fed Chair Jerome Powell mentioned that the Fed could "see through" tariffs because inflation expectations remained anchored. Assuming Powell and his colleagues use a similar framework to adapt their policy stance to the rising threat of new trade tensions, the latest breakeven and consumer expectation data will gain more attention in the coming months.

FIGURE 2

Two-year and 5-year breakeven rates have moved higher thus far in 2025.



Source: Bloomberg, TIAA Wealth CIO. Data through 2/26/2025.

3. Bond yields have dipped—for now.

The recent drop in the 10-year Treasury yield from a January high of 4.79% was initially driven by comments made by Treasury Secretary Scott Bessent that one of the Trump administration's priorities is to lower 10-year bond yields. Bessent clarified that the Treasury does not intend to pressure the Fed to reduce rates and will instead focus on increasing oil production and cost cutting. Over the past couple of weeks, concerns about economic growth have been rekindled by falling consumer confidence, as households anticipate declining affordability and softening labor market conditions due to tariffs and trade uncertainty. This has caused the slide in Treasury yields to intensify, with the 10-year rate now at 4.3%.[2] Looking ahead, we expect the next move in bond yields to be a function of a combination of factors. The most pressing question for investors is whether rising uncertainty will lead to a concrete economic slowdown or will just deal a short-lived blow to consumer and business sentiment. In addition, inflation dynamics and developments related to fiscal policy

2 As of February 26, 2025.

may eventually reassert themselves as key drivers of interest rates. To this effect, last week the House of Representatives approved a budget resolution that includes $4.5 trillion in fiscal room to cut taxes (likely not enough to both extend the Tax Cuts and Jobs Act and implement fresh tax cuts), but also up to $2 trillion in spending cuts (mostly focused on Medicaid and food stamp programs). The balance between tax and spending cuts, and its implications for economic growth and the long-term trajectory of the U.S. fiscal deficit and debt, should continue to be a key area of focus for bond investors.

4. **The Fed should remain in a "wait and watch" mode for now.**

   The sooner-than-anticipated news around tariffs has put the Fed in a tough position, given its dual mandate of maintaining price stability and maximum employment. Tariffs can create both downside risk to growth and upside risk to inflation; the uncertainty surrounding tax cuts and government spending complicates matters even more. As a result, whatever the Fed decides to do next may well be the toughest choice faced by any Fed in decades. That said, Powell's Fed has shown an asymmetrical dovish bias. It is more accepting of higher inflation and less accepting of weaker growth, so if we see more signs of labor market weakness in the near term—even if inflation stays in the 2.5% range—the Fed will likely tilt toward lowering interest rates.

5. **Key fundamentals like corporate earnings are still solid.**

   As of this writing, Q4 2024 earnings are coming in better than expected; earnings are tracking 12% YoY growth for Large Cap equities. While businesses are signaling uncertainty about the path forward for trade and immigration, they are buoyed by expectations for deregulation and solid fundamentals. They are expressing cautious optimism about the outlook for revenue and earnings growth this year.

   Another takeaway from earnings season is that the impact of DeepSeek on the investment plans of U.S. hyperscalers (large data centers providing cloud computing and data management services) appears minimal. Investments are expected to total $290 billion in 2025, up 35% YoY, according to Bank of America Global Research. This is an indication that capital expenditures related to the development and adoption of artificial intelligence (AI) remain robust.

In a recent Focus*Point* titled "Trump Tariffs: Initial reactions and potential impacts," we noted that "uncertainty about the path forward has increased for several of the drivers that have supported strong market performance over the past few years." Greater uncertainty creates a wider range of potential outcomes around the base-case scenario that we outlined in our 2025 Outlook. It is therefore paramount that we monitor both upside and downside risks to our baseline assumptions, including:

- The impact of tariffs on inflation, consumer spending, corporate profit margins, and foreign investments into the U.S.
- How international relationships evolve, given the increasingly protectionist stance by the U.S., the ongoing fragmentation into regional blocs, and growing strategic competition between the U.S. and China.
- How negotiations in Washington around tax and spending cuts, as well as the debt ceiling, affect the bond market and business confidence.
- A larger and earlier-than-expected productivity boost stemming from government deregulation and faster adoption of AI technologies.
- The repercussions of reduced immigration on wage growth, inflation, the labor market and broader economic growth.

- How the unorthodox approach to cost cutting by the Department of Government Efficiency (DOGE) affects overall labor market conditions and the role that the federal government has played in supporting economic and employment growth since Covid.
- The potential for a Ukraine/Russia peace deal leading to lower energy prices for Europe.
- How the Fed is going to adjust monetary policy based on the mix of policy uncertainty, international developments, inflation and labor market conditions—and how economic and market fundamentals respond to still moderately restrictive interest rates.

Conclusions

Markets continue to contend with multiple uncertainties—uncertainty over U.S. government policy, uncertainty surrounding the Fed and interest rates, uncertainty whether inflation is headed up or down—each with the potential to fuel price volatility for stocks and bonds. At the same time, the fundamental backdrop remains supportive of risk sentiment, thanks to broadening corporate earnings growth, a still-resilient labor market, solid household consumption, and now a tentative rebound in manufacturing activity and capital expenditure plans.

Looking ahead, our view is that this tension between healthy fundamentals and rising risks is likely to keep investors cautiously optimistic while limiting the extent to which already elevated valuations expand further. This could translate to broader gains than in 2024, when Mega Cap tech stocks dominated the stock market. However, after roughly 50% gains in stocks since October 2023, we would not be surprised to see equities consolidate and digest these risks for some time, especially given the elevated valuations and bullish investor sentiment.

In this environment, the benefits of diversification across and within asset classes have become more evident. At the same time, the materialization of some of the risks to our baseline scenario described above could make it appropriate to implement tactical adjustments to better position portfolios to reflect evolving fundamentals.

CIO PERSPECTIVES

TIAA Wealth Management

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