Fort Washington Investment Advisors, Inc.

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MONTHLY MARKET PULSE — FEBRUARY 2025

HIGHLIGHTS

- **AI Revolution:** **Developments out of China-based DeepSeek have raised concerns around artificial intelligence's (AI) market leadership. This month's *Spotlight* takes a look at the outlook for AI.**
- **Tariffs:** **The President followed through on his campaign promise and enacted tariffs against Mexico, Canada, and China to stop the flow of illegal drugs and migrants.**
- **Fed Pause:** **Following cuts at their past three meetings, the Federal Reserve (Fed) kept rates unchanged at their January meeting, aligning with investor expectations.**

MONTHLY SPOTLIGHT:

The AI Revolution

Author: Sunit Gogia

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MACRO INSIGHTS

When the Chips Are Down

Stocks were positive in the month of January despite a shot across the bow to the mega-cap tech trade in the U.S. from China-based artificial intelligence company DeepSeek. The U.S. semiconductor industry, led by chipmaker Nvidia, fell near the end of January as open-source DeepSeek showed remarkable efficiency gains that may imply a need for less "compute" to support AI (see our *Spotlight* on the following page for more). As a result, value stocks outperformed growth by over 3% for the month, earning back a small portion of the 20% underperformance last year.

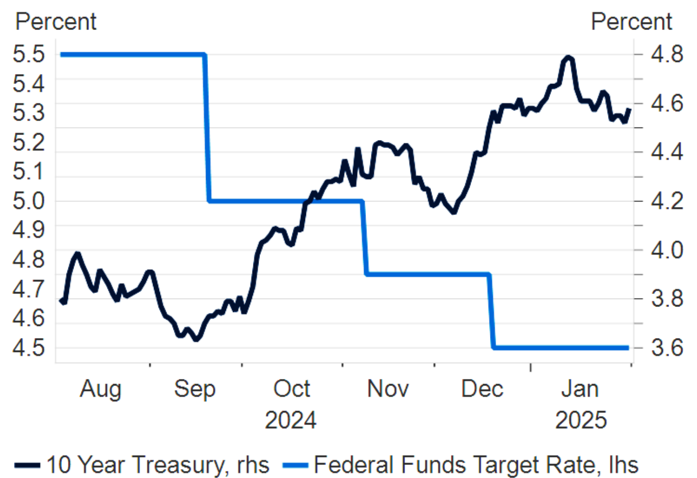
On the last trading day of the month, news circulated that the U.S. planned to impose a 25% tariff on goods from Mexico and Canada (10% on energy supplies), as well as an additional 10% tariff on all goods from China. The broad-based tariffs on Canada and Mexico appear to be politically driven, linked to concerns over immigration and fentanyl trafficking, and are thus likely temporary (if implemented at all). While we expect certain industries in Canada and Mexico to face ongoing tariffs, over the medium to long term, tariffs on China are expected to have a greater impact as the U.S. seeks to reduce dependence on imports from a country deemed a strategic adversary.

The Fed stayed on hold in January, pausing its rate-cutting campaign as expected. The Fed cut 100 basis points from September to December, though is only expected to cut another 50 basis points over the remainder of 2025, reflecting a stable labor market, healthy consumer spending, and somewhat stickier inflation expectations. The 10-year yield declined modestly in January, down 25 basis points from its mid-month peak, but remains nearly 1% higher than just before the Fed's first rate cut in September.

The "Magnificent 7" mega-cap stocks accounted for just under half of the S&P 500's 25% return in 2024 but lagged the market in January. The S&P 500's 3% gain in January, despite fresh AI-related uncertainties, is an encouraging sign. Looking ahead, markets favor stability, and uncertainty around the administration's trade policy could drive both headline and economic volatility. We will be watching these issues closely, though for now, we see tariffs posing a larger risk to specific companies and industries rather than the broader market.

Rate Moves During the Current Cutting Cycle

Despite Fed rate cuts, the 10-year Treasury is up almost 100 basis points since September.



Source: Fort Washington, Fed, and U.S. Treasury.

Chris Shipley
Senior Vice President, Co-Chief Investment Officer
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WHAT TO WATCH

With a balanced labor market, investor attention has been focused on inflation. Short-term inflation expectations have risen amid strong growth and tariff concerns. Although consensus outlooks are positive, investors will monitor data for any signs of labor market weakness.

- January's Consumer Price Index (CPI) reading will be available on February 12th, and Personal Consumption Expenditures (PCE), the Fed's preferred inflation gauge, will be released on February 28th. Investors will focus on the disinflation trend within services.
- The next non-farm payroll report will be released on the morning of February 7th.
- Markets are likely to react to new developments around tariffs, creating volatility in the near term.

MONTHLY SPOTLIGHT

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The AI Revolution

Whether you believe artificial intelligence will lead to a more efficient workforce or that robots will eventually take everyone's job, the AI trade has been an important one to markets and will continue to be moving forward. In 2024, the S&P 500 was up 25%, and artificial intelligence (semiconductors, hyperscalers, cloud services, etc.) accounted for over half of that performance. While this has left some of these companies at seemingly high valuations, many are justifiable. In addition, we expect momentum in artificial intelligence to continue driving positive returns.

AI continues to evolve rapidly; however, it is important to keep in mind that the technology is only in the "early innings" of its long-term contributions to growth and productivity. As a result, we shouldn't be surprised to see new discoveries and enhancements within the space over the coming months and years, similar to past technological cycles. News out of China-based DeepSeek sparked the industry's most recent revelation as their newest model raised questions about AI economics. While there are still some outstanding questions around DeepSeek's release, the company's open-sourced model showed meaningful improvements in cost efficiency compared to U.S.-based models (OpenAI, Meta, etc.). The implications for the broader AI movement can be viewed in both near-term effects and longer-run impacts.

10 of the Largest AI-Related Companies During 2024

Company	2024 Return (%)	Contribution to S&P 500 (%)
NVIDIA	171	5.4
Broadcom	110	1.3
Palantir	99	0.2
Meta	66	1.3
Tesla	63	0.9
Oracle	60	0.3
Amazon	44	1.5
Alphabet	36	1.3
Salesforce	28	0.2
Microsoft	13	1.0
Total		**13.3**

Source: Fort Washington, Bloomberg, and Macrobond.

In the short term, these new developments create uncertainty for specific AI players. For example, NVDA's chip demand has become less predictable given the discoveries that state-of-the-art chips may not be required to make advancements or that AI models might be able to do more with fewer chips than previously believed. However, regardless of this new development, scaling laws (more computing power drives better performance) still appear intact, which should mean that chip demand will continue even as models become more efficient. Many industry experts have referred to Jevons paradox, which states that as technological improvements increase efficiency, overall consumption can actually rise rather than fall.

Looking ahead, the longer-term outlook for AI remains encouraging. The developments from DeepSeek signal that the cost of training and deploying sophisticated AI models continues to decline rapidly. Lower costs should, in turn, broaden adoption and increase the speed at which AI is incorporated throughout the economy. As mentioned above, this could mean that longer-term demand for semiconductor chips increases, especially as AI becomes cheaper and more ubiquitous. Separate from the impact on hardware, as AI systems become more efficient and accessible, companies of all sizes will integrate these technologies into their operations.

As a result, our longer-run outlook for AI is positive for corporations and the economy. We anticipate that as LLMs (Large Language Models, such as Open AI's GPT-4 or Meta's Llama) and other AI models become widely available at low costs, companies will leverage them to build custom solutions for their specific business needs, which will drive productivity gains. This wave of innovation promises to ripple across industries, fueling further investment and spurring job creation in AI-specialized roles.

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CURRENT OUTLOOK

Topic	View	MoM Change	Commentary
Macroeconomic Views			
Economic Growth		–	▸ Recent U.S. economic data remains strong, **led by robust consumer spending**, especially higher income earners. ▸ Wage growth, low savings rates, and a significant rise in net worth (homes and investments) are supporting growth. ▸ The likely extension of the 2017 tax cuts, along with lesser government regulation, should support consumer and business activity. ▸ Recent tariffs on our largest trading partners (Mexico, Canada, China) **present risks to inflation and growth**.
Inflation		–	▸ **Inflation remains on a path toward 2%**, which is expected to continue as service inflation cools. 3- and 6- month annualized PCE currently below 2.3%. ▸ FOMC members have articulated needing further progress on inflation to continue lower rates. ▸ Market expectations for near-term inflation have increased following stronger-than-expected economic data and tariffs; however, longer-run inflation forecasts remain largely grounded. ▸ **Inflation is being driven by shelter and other non-discretionary categories** while goods inflation is near zero.
Monetary Policy		–	▸ The Fed cut rates by 100 basis points in 2024 but aligned with market expectations by **pausing in January**. Strong economic growth, a balanced labor market, and tariff concerns have reduced consensus expectations for cuts in 2025. ▸ Investors anticipate less than 50 basis points of cuts in 2025, implying a **terminal rate of around 3.9**.
Fiscal Policy		–	▸ Flexibility within fiscal policy is being reduced as federal debt levels swell and **higher interest costs** consume a larger portion of government outlays. ▸ Deficits are expected to remain elevated under the Trump administration amid current policy proposals. However, cost savings through government efficiency programs could partially offset deficits.
Market Valuations			
Rates		–	▸ Yields began January by moving higher but ended the month generally where they began the year as investors assessed current economic data and the potential impact of new policies on inflation. ▸ We anticipate the **magnitude of expected rate cuts will continue shifting** with new economic data and developments around executive branch policies, presenting opportunities for tactical adjustments. ▸ Long rates are toward the higher end of our expected range and exhibit value at current levels.
Credit		–	▸ Credit spreads remain below historical averages, supported by continued U.S. growth. ▸ We believe **current fixed income valuations are expensive,** and credit spreads represent little upside. ▸ Investment grade spreads (10yr BBB Industrials) ended November at their 9th percentile and high yield (single B corporates) at their 1st percentile since the 1990s.
Equity		–	▸ Uncertainty over market leadership (Magnificent 7) increased following developments out of China, showing that new AI models were more cost-efficient than previous U.S.-based versions. ▸ **Valuations remain stretched** after the S&P 500 advanced almost 3% in January, on top of the 25% in 2024. ▸ Market breadth has improved since the second half of 2024, but small-cap stocks need to see more robust fundamentals to continue that momentum. ▸ Corporate earnings for Q4 have largely exceeded expectations so far, but full-year 2025 earnings expectations may be difficult to achieve.

MARKET DATA & PERFORMANCE | AS OF 01/31/2025

U.S. Snapshot	Current	6 Months Prior	1 Year Prior
Core Inflation (YoY%)	2.8	2.7	3.1
Unemployment Rate	4.1	4.2	3.7
Real GDP (YoY%)	2.5	3.0	3.2
Retail Sales (YoY%)	3.9	2.9	0.3
30-Year Mortgage Rate	7.0	6.8	6.7
10-Year Treasury	4.5	4.0	3.9
US Corporate IG Yield	5.3	5.1	5.1
US Corporate HY Yield	7.2	7.6	7.8

TOTAL RETURNS

Asset Class	MTD	QTD	YTD	1 Year	3 Years*	5 Years*
Equity						
Russell 3000 Index	3.2%	3.2%	3.2%	26.3%	11.4%	14.6%
S&P 500 Index	2.8%	2.8%	2.8%	26.4%	11.9%	15.2%
S&P Midcap 400 Index	3.8%	3.8%	3.8%	20.4%	8.9%	11.8%
Russell 2000 Index	2.6%	2.6%	2.6%	19.1%	5.6%	8.7%
MSCI World Index	3.6%	3.6%	3.6%	21.9%	10.1%	12.6%
MSCI World Excluding US	5.0%	5.0%	5.0%	10.0%	5.7%	7.1%
Fixed Income						
Bloomberg US Aggregate	0.5%	0.5%	0.5%	2.1%	-1.5%	-0.6%
US Corporate Investment Grade	0.6%	0.6%	0.6%	2.8%	-0.9%	-0.1%
US Corporate High Yield	1.4%	1.4%	1.4%	9.7%	4.3%	4.5%
Emerging Market Debt	1.4%	1.4%	1.4%	9.9%	0.9%	0.1%
US Treasury (7-10 year)	0.5%	0.5%	0.5%	-0.2%	-3.4%	-1.8%
Cash	0.4%	0.4%	0.4%	5.3%	4.1%	2.5%

Source: Fort Washington and Bloomberg. *Returns longer than 1 year are annualized. Past performance is not indicative of future results.

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