James Investment Research, Inc.

Market Commentary

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JAMES
INVESTMENT RESEARCH, INC.

Key Insights

- **Market Volatility and Defensive Rotation:** The S&P 500 reached an all-time high on February 19 before reversing to a 1.4% monthly decline amid significant volatility. Defensive sectors, value stocks, and international markets outperformed as investors sought safety.
- **Inflation Concerns and Monetary Policy:** Inflation expectations surged to multi-year highs with 5-year expectations reaching 3.5%, the highest since 1995. Markets pushed rate cut expectations to July 2025 while Treasury yields fell as investors balanced inflation fears with growth concerns.
- **Trade Policy and Economic Slowdown:** President Trump's proposed 25% tariffs on automobiles, semiconductors, and pharmaceuticals rattled markets already concerned about economic deceleration. February's Services PMI contracted for the first time in over two years while consumer confidence experienced its sharpest decline since August 2021.
- **Corporate Earnings Resilience:** Q4 2024 delivered strong results with 75% of S&P 500 companies beating earnings estimates and 18.2% blended (year-over-year) earnings growth. However, cautious guidance and elevated valuations (forward P/E of 22.2) highlighted the disconnect between current performance and future expectations.

Monthly Recap

The S&P 500 Index reached an all-time high on February 19 before reversing to a 1.4% monthly decline amid substantial volatility. The tech-heavy Nasdaq Composite Index suffered a steeper 3.9% monthly loss with the "Magnificent 7" tech giants experiencing substantial selling pressure after their earlier leadership had propelled markets to record highs. Defensive sectors including Consumer Staples (+5.1%) and Real Estate (+4.1%) strongly outperformed, while Consumer Discretionary suffered the steepest losses (-6.9%). Value stocks demonstrated better resilience than growth counterparts across all capitalizations and large-cap stocks demonstrated greater stability than small-caps. International markets outpaced domestic equities, and safe-haven assets attracted major inflows as gold posted strong gains (+2.1% for February, +8.9% YTD). The 10-year Treasury yield declined 25 basis points from 4.54% on January 31 to 4.20% by month-end (after peaking at 4.79% in mid-January), driving the Bloomberg US Aggregate Bond Index higher (+2.2%) as falling interest rates boosted bond prices.

MAJOR CONCERNS

Inflation Concerns and Monetary Policy

Inflation concerns intensified substantially in February, with University of Michigan's 12-month inflation expectations holding at 4.3% (highest since November 2023) and 5-year expectations jumping to 3.5% (highest since 1995). The Conference Board's measure surged even more dramatically to 6.0% from 5.2%. In response to persistent inflation and economic uncertainty, markets pushed back expectations for Federal Reserve (Fed) easing, with the first rate cut now priced for July 2025 and only about 40 basis points of cuts anticipated for the entire year.

Trade Policy & Economic Slowdown

President Trump's trade policy announcements significantly impacted markets, including plans for 25% tariffs on car imports starting April 2, with additional tariffs proposed for semiconductors and pharmaceuticals. These followed earlier tariff declarations targeting Mexico and Canada, though mixed signals emerged with mentions of a potential new China trade deal and European Union willingness to negotiate. Simultaneously, economic growth concerns mounted as consumer sentiment deteriorated sharply—the Conference Board Index fell to 98.3 from 105.3, the steepest decline since August 2021, with expectations falling below the recession-warning threshold of 80. Supporting these concerns, February's Services

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Purchasing Managers' Index (PMI) contracted for the first time in over two years, existing home sales dropped 4.9%, retail sales weakened, and the Citi Economic Surprise Index turned negative, collectively suggesting a meaningful economic deceleration.

Earning Strength & Corporate Resilience

According to FactSet, Q4 2024 delivered robust corporate performance, with 97% of S&P 500 companies having reported results. Among these, 75% posted positive earnings per share surprises, while 63% exceeded revenue expectations. The blended year-over-year earnings growth rate reached 18.2%, marking the strongest performance since Q4 2021. The S&P 500's forward P/E ratio stood at 21.2, considerably above both the 5-year average (19.8) and 10-year average (18.3), suggesting stocks remained relatively expensive despite recent market declines.

Topic of the Month: Tariffs - Economic Goals and Complex Consequences

Tariffs are duties assessed as a percentage of an imported good's value, initially paid by the importer but ultimately often passed on to consumers through higher prices. Under U.S. law, the president has broad authority to modify these tariffs when addressing issues like unfair trade practices, threats to national security, or wartime concerns.

The implementation of tariffs would represent a notable shift from the free trade paradigm that has dominated U.S.-China relations for decades. This previous free trade relationship created a complex strategic dynamic that can be understood through game theory. In absolute terms, free trade delivered important benefits to the US, including lower consumer prices for everyday goods, expanded markets for American companies, efficiency gains through specialization, and innovation spurred by competitive pressures. American consumers, particularly lower and middle-income households, gained access to more affordable goods, while many U.S. companies prospered by tapping into China's growing market.

However, in relative terms, China has gained more from this relationship, achieving rapid industrial development and technology transfer, massive trade surpluses with the US, accelerated Gross Domestic Product (GDP) growth (often 2-3x faster than US growth), and economic leverage that translates to geopolitical influence. China leveraged access to U.S. markets and technology to transform from a regional power to America's primary geopolitical competitor more quickly than anticipated. This relative shift in power dynamics represents a strategic challenge for the U.S., highlighting a classic security versus prosperity dilemma in international relations.

From a game theory perspective, free trade isn't a purely zero-sum game (where one side's gain equals another's loss), but rather a positive-sum game in absolute terms where both countries can become wealthier simultaneously. Tariff wars, however, tend to be negative-sum games. When both sides implement protective tariffs, consumer prices rise in both countries, supply chains are disrupted, market efficiencies are lost, and overall economic growth slows. This helps explain why free trade persisted despite relative power shifts - the absolute gains were important enough to outweigh concerns about relative position for many years; at least until the covid pandemic highlighted U.S. vulnerabilities from an overdependence on Chinese goods.

The Trump administration views tariffs as a means to reclaim the world's respect, gain leverage in negotiations, and address specific issues like drug trafficking and immigration. Some analysts suggest that the threat of tariffs may be primarily a negotiating ploy - a strategic maneuver designed to pressure trading partners into lowering their own trade barriers or making other concessions, without the U.S. needing to implement its threatened tariffs. This perspective highlights the strategic dimension of tariff policies, where the signaling effect might achieve desired diplomatic outcomes while avoiding the economic disruption of actual implementation.

While tariffs are seen as a potential revenue source, their ability to generate substantial income remains questionable due to slower economic growth and retaliatory measures from other nations. Kevin Hassett, head of President Trump's National Economic Council, said a 10% levy on imports from China would generate "between $500 billion and a trillion dollars over 10 years."

Market reactions to tariff announcements have evolved over time. Initially, markets were skeptical about the implementation of broad tariffs, but this skepticism has given way to increased volatility as policy became reality. The timing of these tariffs is particularly crucial, coinciding with existing resource scarcity and tight labor markets, potentially amplifying their economic impact.

Price Effects and Market Adaptation

The immediate effects of tariffs manifest in several key areas of the economy, with complex ripple effects that extend beyond directly targeted goods. A compelling example from a 2020 American Economic Review study

of President Trump's 2018 China tariffs illustrates this phenomenon. When tariffs were imposed on washing machines, prices predictably increased for these directly affected products. However, the study revealed an interesting secondary effect: prices of dryers, which weren't subject to tariffs, also rose significantly. This phenomenon, often termed "excuseflation," occurs when companies use broader economic narratives about rising prices as justification to increase prices on unaffected products.

However, several factors may mitigate the inflationary impact of tariffs. First, exporters might choose to absorb part of the tariff costs by lowering their prices to maintain market share, while retailers might accept reduced profit margins rather than pass on the full cost to consumers. Second, tariffs typically represent a one-time price shock rather than an ongoing inflationary pressure.

The impact of tariffs is not evenly distributed across society. Lower-income households, who spend a larger proportion of their income on physical goods, bear a disproportionate burden of tariff-related price increases. Specific industries face particular vulnerabilities - the auto industry, with its highly integrated North American supply chain, is especially susceptible to tariff disruptions.

Corporate profit margins face particular pressure as companies must decide whether to absorb increased costs or pass them on to consumers. The ability to absorb these costs depends on a company's existing profit margins and cost structure. For instance, the management of the footwear manufacturer, Crocs, anticipated an $11 million headwind to gross profit due to additional tariffs.

The evolution of trade patterns following tariff implementation reveals a complex dynamic of diminishing flexibility. When President Trump's initial tariffs targeted China specifically, many companies successfully redirected their supply chains to countries like Vietnam and Mexico, helping to mitigate the immediate economic impact. This is evidenced in recent trade data: between 2018 and 2023, U.S. imports from Mexico surged by 38% while those from China declined by 20%, leading to Mexico supplanting China as America's top trading partner.

However, this shift doesn't necessarily represent true onshoring of manufacturing to North America. During the same period; Mexico's imports from China increased by 37%, suggesting a more complex dynamic: Chinese companies are increasingly establishing manufacturing facilities in Mexico, importing raw materials and industrial components from China for processing, and then exporting finished products labeled "Made in Mexico" to the U.S.

More concerning is the "sticky" nature of remaining imports from China. The goods that were easiest to source from alternative locations have largely already been shifted, leaving behind products that are more difficult or impossible to substitute. These might include goods requiring specialized manufacturing capabilities, specific technical expertise, or complex supply chain integration that took years to develop. Consequently, new rounds of tariffs could have a more pronounced inflationary impact than previous measures, as companies face fewer options for avoiding these costs through supply chain restructuring.

Policy Response and Global Implications

The complex impact of tariffs is challenging to predict since their final size and implementation timeline often shift during negotiations, making it difficult to accurately price these policies into fundamental valuations. Recent currency fluctuations and elevated short-term inflation expectations underscore this persistent market uncertainty.

Retaliatory measures from trading partners can dramatically amplify the negative economic effects, creating a destructive cycle of escalating trade barriers. Such tit-for-tat tariff escalation can severely disrupt global supply chains, depress international trade volumes, and potentially trigger a broader economic slowdown that affects nations beyond those directly involved in the trade dispute.

The Federal Reserve plays a crucial role in managing the economic impact of tariffs through its monetary policy decisions. Fed officials maintain a deliberately cautious stance, emphasizing their data-dependent approach given the uncertainty surrounding tariffs' impact on inflation. While the central bank had previously signaled potential rate reductions starting in September, recent developments may alter this trajectory. Market expectations for rate cuts have decreased compared to last year, suggesting that the "higher for longer" interest rate environment might persist.

The Fed's decision-making process is particularly focused on inflation expectations, which serve as a critical indicator of future price pressures. Atlanta Fed President Raphael Bostic has explicitly stated that if tariffs begin to influence inflation expectations, monetary policy intervention would be warranted. The current economic landscape presents a unique set of circumstances that complicate the Fed's policy choices. A combination of low unemployment,

above-trend economic growth, robust consumer spending, and businesses more inclined to pass on cost increases creates potential inflationary pressures.

The U.S. dollar's strength typically increases with tariff implementation, though this creates its own set of challenges. While the dollar may become a one-way bet during trade wars, a stronger dollar can have a deflating influence on corporate profits generated overseas. The strong dollar environment that often accompanies tariff implementation can make imports cheaper for domestic producers, partially offsetting the tariff impact for companies that rely on other imported inputs. However, new tariffs often work against U.S. competitiveness by reducing domestic manufacturers' access to cheap imported components.

In conclusion, tariffs are a complex policy tool with a wide array of potential consequences. While they may achieve certain short-term goals, their effectiveness in achieving structural economic changes like onshoring appears limited and more nuanced than initially anticipated. The emergence of sophisticated supply chain adaptations, including the shift of manufacturing to Mexico while maintaining dependencies on Chinese inputs, suggests that traditional protectionist measures may need to be reconsidered in an era of highly integrated global manufacturing networks. The Federal Reserve's response to tariffs and their impact on inflation and growth adds another layer of complexity, requiring careful monitoring and data-driven policy decisions. As global trade patterns continue to evolve and adapt to tariff pressures, policymakers must carefully weigh the potential benefits of tariffs against their costs, including their disproportionate impact on lower-income households and the risk of retaliatory measures from trading partners.

Conclusion

February 2025 marked a pivotal moment for markets as the optimism that drove stocks to record highs earlier in the month gave way to sobering economic realities. The combination of resurgent inflation concerns, aggressive trade policy proposals, and signs of economic deceleration created a challenging environment that prompted a defensive positioning shift among investors. While strong corporate earnings provided some fundamental support, the growing disconnect between current results and forward expectations suggests continued volatility ahead as markets navigate the complex interplay between policy decisions, inflation pressures, and growth prospects. Investors appear increasingly cautious about the sustainability of the post-election rally as economic data and policy developments warrant a more measured outlook.

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