

Monthly Download

February 2025

Summary

Market performance was mixed and volatile in February amid ongoing uncertainty around US policy implementation, mixed inflation readings, and weaker US consumer data. Trade war developments dominated headlines, while market attention shifted from overheating inflationary concerns to near-term economic weakness. Foreign markets were more resilient than the US as investors sharpened their focus on growth risks and rich valuations in the US. Economic concerns spilled over into the bond market, leading to a decline in yields on increased expectations of further Federal Reserve rate cuts.

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Market Overview

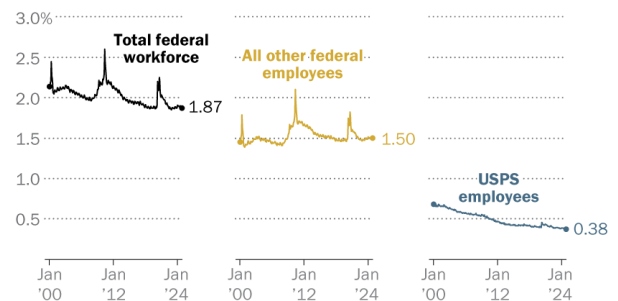
- ◆ **Equity markets** endured another wave of volatility as investors weighed implications of tariff discussions with Canada, Mexico, and China and softer economic readings paired with a hot January CPI report. Performance of the Magificent 7 stocks did not live up to their name, contributing to the underperformance of US stocks relative to global markets. China and Europe were bright spots during the month.
 - US Large Cap stocks (S&P 500) fell 1.3% for the month as mega cap technology stocks stumbled. The S&P 500 index underperformed the equal-weight index as Discretionary, Communications, Industrials, and Technology posted negative returns. Despite the modest pullback in US equity markets, earnings reports remained strong with 10 of 11 S&P 500 sectors showing positive earnings growth in the 4th quarter and overall year-over-year earnings growth was the highest in 3 years. Index gains for the year fell to 1.4%.
 - US Small Cap stocks (Russell 2000) delivered negative returns of 5.4% as growth concerns outweighed falling rates. Technology, Industrials, and Health Care were the largest detracting sectors during the month. January gains were erased and year to date returns now stand at -2.9%.
 - Non-US stocks (MSCI EAFE Net) rose 1.9% in February, driven by outperformance of European equities. Prior to a tense meeting between Trump and Zelensky at the end of the month, investors increasingly priced in the likelihood of a Ukraine peace deal. Financials were the top performing sector and European defense stocks are benefiting from a renewed focus on domestic production in Europe. Year to date returns are now up 7.3%.
 - Emerging Markets (MSCI Emerging Markets Net) added 0.5% during the month as enthusiasm around DeepSeek and President Xi possibly signaling an improved regulatory environment for large Chinese technology companies supported returns. Concerns remain regarding the Chinese real estate market which impacted more GDP-sensitive sectors and companies. Emerging markets are now up 2.3% in 2025.
- ◆ **Interest rates** fell across the curve in February, with the 10-Year US Treasury yield ending the month at 4.23%, down from 4.57%. The Federal Reserve maintained a cautious stance despite the hotter CPI report, a decline in consumer confidence, and broader macro uncertainty, emphasizing the need for more improvement on the inflation front. Markets are pricing in the next rate cut for June.
 - High Grade Taxable bonds (Bloomberg US Aggregate) returned 2.2% as bond markets focused on weaker US consumer data and growth risks rather than higher than expected inflation numbers. Year to date gains now stand at 2.7%,

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- Municipal bonds (Bloomberg 1-10 Year Muni Bond) had a strong February, notching gains of 0.9%. Municipals underperformed taxable bonds, but the space saw support from strong issuance and the broader risk-off sentiment driving interest rates lower. Year to date gains for municipal bonds are now 1.6%.
- Investment Grade bonds were supported by strong corporate fundamentals during the month, which helped contain spreads. High Yield spreads experienced a slight widening and underperformed their Investment Grade counterparts. Investment Grade bonds (Bloomberg Corporate Investment Grade) and High Yield bonds (Bloomberg Corporate High Yield) returned 2.0% and 0.7% in February, respectively. Year to date returns for Investment Grade and High Yield bonds are now up 2.6% and 2.1%, respectively.
- ◆ **Commodities** (Bloomberg Commodity Index) climbed 0.8% during the month with varied performance across sectors. Oil fell 3.8% on oversupply concerns and President Trump's announcement of tariffs on Canada and Mexico. While oil suffered, natural gas surged 26.0% due to temporary supply shortages and cold weather. After a wave of strong performance, Gold prices retreated at the end of the month after testing the 3,000 level, but still finished up 0.5%. Soft commodities declined in February, reinforcing negative trends in agricultural markets.

Economic Commentary

Downsizing of the federal workforce has raised questions about the potential impact on US employment markets. For context, total federal government civilian employment amounted to just over 3 million workers at the end of 2024, including 600,000 who work for the US Postal Service which operates as a semi-autonomous independent federal agency. According to data from the Bureau of Labor Statistics, the number of federal workers, excluding the Postal Service, has risen by just over 1% per year since 2000 and its share of the civilian workforce has held steady at around 1.5% for over 10 years. In January, the Trump administration offered members of the federal workforce a buyout in which employees would receive 8 months of paid severance if they voluntarily resigned. This offer period ended February 26th and approximately 77,000 federal employees were reported to have accepted the offer, which equals about 3% of the total federal workforce. Departing federal employees will still be considered employed in employment surveys until September, but they are free to find other jobs in the meantime and will not be required to work. Shortly after the buyout period ended, federal agencies began targeting the 220,000 “probationary” workers, or those who were in their positions for less than two years and thus lacked normal federal employee worker protections. The Trump administration has instructed Federal departments and agencies to initiate “large-scale reductions in force” by March 13th as a more aggressive phase of cutting is set to begin beyond probationary employees. The White House has not released a precise number of federal firings so far, but the impact of the federal workforce reduction could cloud labor reports in the coming months. The February jobs data scheduled for release on March 7th is unlikely to show much impact since the cutbacks



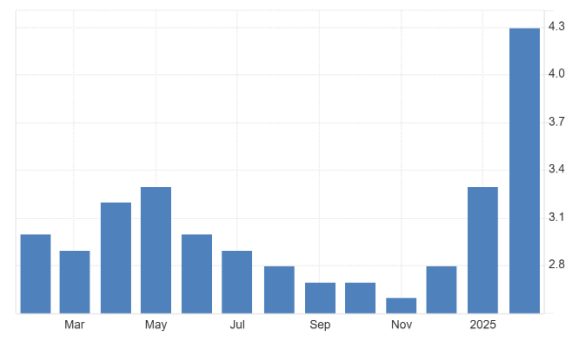
Federal Civilian Workers as a % of all US Non-Farm Payroll Employees, Not Seasonally Adjusted
Source: Pew Research Center, Bureau of Labor Statistics. Note: Employment spikes in mid-2000, mid-2010, and mid-2020 primarily represent temporary census workers.

were just getting started during the report's reference month. Weekly jobless claims, which have been very subdued over recent months and do not include federal workers, popped to 242k last week. Washington D.C. is seeing a more predictable uptick in jobless claims, with claims in the district rising by 4x since the election from just 500-600 to over 2k for the latest data. The question is whether the public sector signals challenges for the broader private sector to come if business owners and management teams get concerned about policy uncertainty and reverse the business

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confidence gains registered post-election. Broader employment weakness could give the Federal Reserve more room to reduce interest rates but would also raise concerns about economic health and the possibility of recession.

President Trump's voluminous tariff orders strained financial markets in February with additions to the Canadian and Mexican tariffs that were delayed at the end of January, as well as additional Chinese tariffs, and "reciprocal" tariffs to all US trade partners. While the tariffs that have been enacted so far have been minor relative to what has been proposed, the uncertainty is weighing on US businesses and consumers. To date, Trump has announced and delayed 25% tariffs on imports from Canada and Mexico until early March but implementation seems to be in place as of this writing¹. A 10% tariff on imports from China took effect on February 4th, with an additional 10% tariff announced at the end of February. Additionally, 25% tariffs on steel, aluminum, lumber, and autos are set to take effect in March and April. President Trump also ordered a review process to enact reciprocal tariffs on foreign nations that charge higher tariffs on US goods than the US charges on the foreign nation's goods. The target date for completing the review on reciprocal tariffs is set for April 2nd. It is still yet to be seen whether these moves are negotiating tactics or will come to fruition, but President Trump has emphasized that he views these tariffs as a way to compensate for other tax cuts. The "on again off again" tariff drama will impact production, hiring, and investment for businesses with significant exports or imports. Tariffs and retaliatory responses by other countries have the potential to both raise prices and slow economic growth. Businesses and consumers have already accelerated production and purchases in anticipation of tariff implementation, leading to strong economic data post-election. This pull-forward of demand has also awakened inflation data and expectations. The January Consumer Price Inflation (CPI) report was hotter than expected and consumer inflation expectations spiked to 4.3% in February following a 3.3% reading last month. Treasury Secretary Scott Bessent sought to tamp down increasing inflation expectations and expressed his confidence that the inflation rate was headed towards 2% imminently in interviews at the end of February. Softer inflation data would be welcomed by Fed officials, but we would expect concern over cutting rates near-term given the inflation expectation numbers. Markets are pricing in the next rate cut for June, giving Fed officials time to reconcile tariff threats, inflation expectations, and softer economic data for a path forward on US rates.

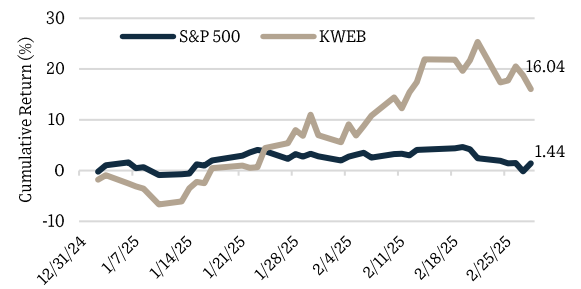


Surveys of Consumers: 1-Year Inflation Expectations
Source: University of Michigan. Data as of 2/21/25.

Chinese stocks have surged this year, led by their version of mega cap technology companies. Despite renewed trade war concerns, the MSCI China Index has returned 12.8% year to date, while the S&P 500 has only delivered 1.4% as of the end of February. There were a few catalysts behind the strong performance despite headwinds from additional tariff announcements and heightened US-China tensions. First, President Xi held a gathering of China's top technology executives, signaling a shift from Beijing's previous regulatory crackdown to renewed government support of the sector. Second, Alibaba announced plans to invest \$53 billion into artificial intelligence over the next three years eliciting comparisons to the Magnificent 7 capex cycle that has driven US markets over the past 2 years. Third, Chinese Artificial Intelligence (AI) startup DeepSeek reopened access to its programming interface, a key component of its AI model adoption. The release of Deepseek's R1 model triggered the initial rally in January (while US technology companies sold off), challenging US-based artificial intelligence companies by claiming superior performance at

¹ Commerce Secretary Howard Lutnick alluded to ongoing conversations with Mexican and Canadian leaders and the administration also exempted US automakers until early April.

significantly lower costs. DeepSeek's improved efficiency and cost savings has the potential to have a ripple effect into other industries by lowering the barrier of entry for the use of AI. Chinese electric car maker BYD announced in February that it would be integrating DeepSeek into its new assisted driving system across a range of its cars, including a 69,800 yuan (\$9,555) low-cost vehicle. Though regulatory restrictions will likely continue to be a headwind for driver-assistance software, this is just an example of the competitive edge that Chinese companies may gain by integrating the technology offered by DeepSeek. Chinese internet stocks experienced three straight years of negative returns given investor outflows before turning positive in 2024 due to recurring concerns over the country's financial system, real estate bubble, and decline in consumption activity. Optimism around Chinese stocks returned in September 2024 coinciding with government stimulus measures to help boost domestic demand. While Chinese technology companies look well positioned and are mostly cheap on a valuation basis to the US, a broader China recovery is less certain. Employment, consumer sentiment, real estate, and demographics remain real issues even without additional US tariffs. While the Technology sector is driving markets, it is less likely to provide solutions for the broader challenges that remain in place.



Total Return: S&P 500 index vs. KWEB

Source: FactSet. Data as of 2/28/25.

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