

Monthly Download

January 2025

Summary

Positive market performance continued to begin 2025 but with a significant shift in leadership as markets adjusted to new US policy under President Trump and China's new artificial intelligence application "DeepSeek". Foreign markets outperformed the US and Technology was the only sector to post a loss in January. Interest rates leveled off after the Federal Reserve officially paused their rate cuts that started in September 2024. Investors are now focused on US tariff policy as Trump announced and then delayed 25% tariffs on goods from Canada and Mexico.

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Market Overview

- ◆ **Equity markets** continued their positive momentum to start 2025 on the back of strong 4th quarter earnings reports and positive economic data reports. Developed markets in Europe led returns in January despite their challenging outlook and US dollar strength. Investors picked up cheaper valuations in France, Germany, and Sweden. Lower weightings to Technology in Europe and Japan also supported performance. The MSCI All Country World Index returned 3.4% to start the year.
 - US Large Cap stocks (S&P 500) gained 2.8% for the month as 10 out of 11 sectors posted positive returns. The one sector that was negative happens to be the S&P 500's largest weighting in Technology. The GICS Technology sector declined 2.9% for January weighed down by Nvidia which declined 11%. The equal-weighted Technology sector was up 3.2%. Financials were the key driver of performance for the month adding almost 9% on strong earnings from big banks like JPMorgan, Goldman Sachs, Wells Fargo, and Morgan Stanley.
 - US Small Cap stocks (Russell 2000) rebounded from their December swoon but were in-line with Large Cap US performance adding 2.6% to start the year. Regional banks saw strong returns of just over 6% for January, not quite keeping up with large banks but benefiting from their outlook for consolidation, deregulation and tax cuts.
 - Non-US stocks (MSCI EAFE Net) added 5.3% for January, upending at least for a month, the narrative on US dominance of global markets. European countries delivered the strongest performers as investors were attracted to cheap valuations. European banks were a leading positive contributor to the region's returns.
 - Emerging Markets (MSCI Emerging Markets Net) lagged other areas of global equity markets returning only 1.8% for January as both China and India posted modestly negative returns to offset strength in Latin American countries like Brazil and Columbia.
- ◆ **Interest rates** leveled off to start 2025 despite peaking mid-month at 4.80% for the 10-Year US Treasury. The yield ended January exactly where it started on the 10-Year Treasury at 4.57% which provided some relief for fixed income investors from the move higher over the 4th quarter of 2024. The Federal Reserve did not change their benchmark federal funds rate at the January meeting as expected by markets. Rate cut expectations are now down to just 50bps over the course of 2025 and it is possible the Fed's rate cutting cycle may be over.
 - High Grade Taxable bonds (Bloomberg US Aggregate) delivered their yield given the lack of change in interest rates, adding 0.5% to start the year.

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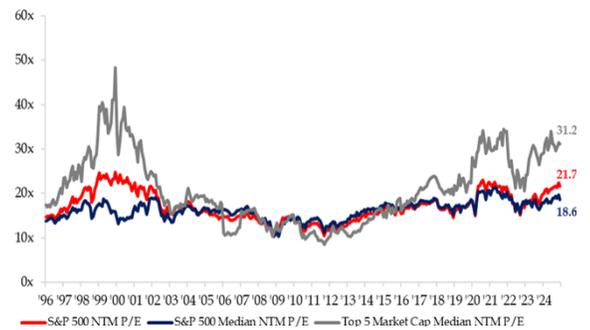
- Municipal bonds (Bloomberg 1-10 Year Muni Bond) outperformed taxable bonds with a 0.7% return in January despite concerns in the California market on credit quality given the tragedy of the Los Angeles fires.
 - High Yield spreads tightened in January as investors believe new economic policies should benefit corporate earnings and maintain or improve the credit outlook. Investment grade spreads were flat but lower-quality B-rated spreads declined by 25bps. Investment Grade bonds (Bloomberg Corporate Investment Grade) and High Yield bonds (Bloomberg Corporate High Yield) returned 0.6% and 1.4% in January, respectively. High Yield bonds saw strong outperformance given the decline in credit spreads for lower-rated bonds.
- ◆ **Commodities** started 2025 strong with a 4.0% return in January. Outside of oil, commodities are seeing a pickup in interest with investors for base metals and raw materials. Gold returned 7% as investors continue to position for higher inflation despite a strong month for the US dollar. Many base metals and building materials saw increases in anticipation of the rebuilding effort in Los Angeles in the coming months and year. Lumber futures rose almost 8% in January. Oil and natural gas were muted. Natural gas initially spiked given frigid weather on the East Coast but pulled back as warmer weather followed and Trump policies did not immediately focus on natural gas policy.

Economic Commentary

China's Artificial Intelligence (AI) Application "DeepSeek" rocketed into the forefront of investor's attention after releasing an updated version of its AI application in late January. The updated version gradually garnered attention the week of January 20th and was picked up by financial media after numerous prominent venture capitalists touted its capabilities. The message was that DeepSeek appeared to be as advanced and effective as popular tools like ChatGPT and according to its owners had been developed at a fraction of the cost to date being plowed into AI applications from the likes of OpenAI, Meta, and Google. After a weekend of continued DeepSeek momentum on adoption and

downloads peaking with it being the #1 application on Apple's App Store, US markets sold off dramatically on Monday, January 27th on concerns that the cheaper-funded DeepSeek version could upend the capital expenditure cycle that had been driving Magnificent 7 names. The timing of DeepSeek's arrival comes after President Trump delayed implementation of legislation that had bipartisan approval banning TikTok in the US. Let us put aside for a moment the idea that if one was concerned enough about TikTok storing data on servers located in China, one should be very concerned about an AI application doing the same thing¹. Logic and

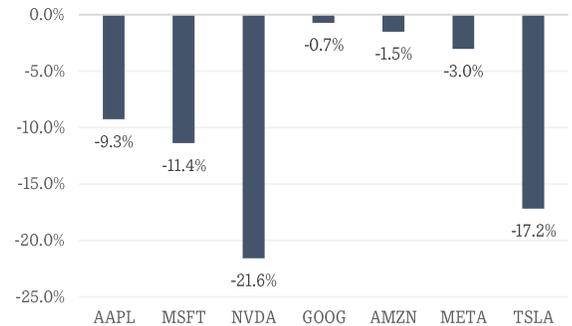
consistency are usually checked at DC's borders on behalf of politics. Whether it is DeepSeek or another application, the emergence of AI competition cast a shadow on market assumptions that have driven market performance over the past year and multiples for the Magnificent 7 well above the broader market. The question is whether AI competition challenges the assumptions that: 1) that the US has dominance in all things AI, 2) that AI development is creating a massive capital expenditure and hardware cycle, and 3) that AI is driving an increase in US power demand. Markets at the end of January punished all of these themes, most notably hardware in the form of Nvidia, which declined 17% on January 27th, marking the largest single-day decline in market capitalization ever. And specific Utility stocks that had been market darlings in 2024 saw massive price declines. Constellation Energy had seen its stock return 199% since the beginning of 2024 going into January 27th, only to lose 21% in a single day. US dominance in AI will be a unique



S&P 500 Index Median Price/Earnings vs. Top 5 Weightings
Source: Strategas, FactSet. Data through 12/31/24

¹ DeepSeek's privacy policy states "We store the information we collect in secure servers located in the People's Republic of China", the application collects a lot of data on its users in addition to chat history and queries.

challenge, but there is little question the US is in the best position to maintain innovative leadership. The US has the companies at the forefront of using the application and the engineering talent as well as the dollars needed on spending (even at reduced amounts). The challenge is the debate on closed-source versus open-source nature of AI. There is a reasonable argument that open-source models may have a distinct advantage for development and broader application but creates risk for any company behind that business model to profit from (ChatGPT is closed-source for now). China is likely the biggest competitor in the space to the US but is limited by its requirements for restricted access and its closed internet and information structure. Internet sleuths were already testing how DeepSeek would respond to inquiries regarding Tiananmen Square, and there is a fundamental question of how to train an application to be intelligent while forcing it to ignore some aspect of factual data. The capital expenditure cycle has created an almost self-fulfilling loop for the Magnificent 7 stocks. Nvidia's six largest customers by revenue are the other six Magnificent 7 companies in Apple, Microsoft, Google, Amazon, Meta, and Tesla. Companies like Microsoft and Meta have received headlines for their capex numbers with Microsoft committing to 80 billion in the space in 2025. Return on those investments is not guaranteed, and there is an open question in markets whether this spending will be justified with future revenues. For now, investors have given the companies the benefit of the doubt, but at some point, this spending cycle will be judged on its returns. Competition on the pricing of the capex spending is not a bad thing for the overall market, unless you are Nvidia. For many other companies outside of the semiconductor industry like software, a reduction in hardware spending to drive AI development



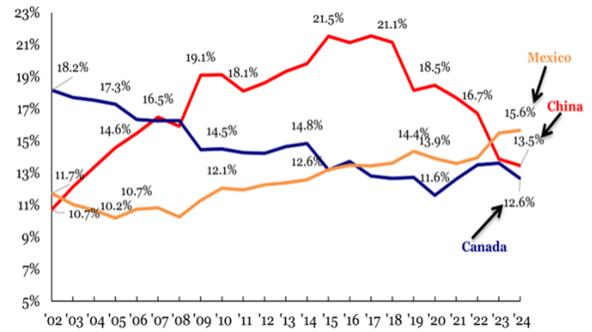
January 31st closing price versus all-time high for Mag7 Stocks
Source: Yahoo! Finance, price return only

is a net positive. Interestingly, while markets have recovered in early February from the January 27th decline despite tariffs, Nvidia is just barely above its closing price on January 27th. Nvidia's earnings report on February 26th could change market's outlook but for now investors are cautious. Prior to 2022, US power consumption had not grown from the start of the century despite growth in the US population by roughly 50 million people. As we have detailed in other publications, US power consumption has started to change and we expect growth in power demand to continue. Power demand is not growing "just" from AI development and capex. It is certainly a component, but power demand is also increasing from electrification, onshoring of US manufacturing, bitcoin mining, and data. Data is a large component of AI development and if there is less need for hardware or expensive chips, we do not see an environment where there is less need for data, AI-driven or otherwise. It is early, but we have seen no comments on less spending during recent earnings reports from Microsoft, Meta, and Google with all of the companies committing to 2025 capex spending. We do agree that markets should be more cautious with their outlook for AI. The assumption to date has been the AI revolution will be great for everyone, especially the largest companies. History tells us a different story, that innovative and disruptive technology is good overall, but can be bad, or very bad, for established players in an industry or for our largest companies. We expect the AI cycle to continue, but perhaps with less momentum, and more discretion, which is not a bad thing for markets.

President Trump's Tariff Policy arrived earlier than investors expected in the form of 25% tariffs on US neighbors Canada and Mexico as well as an additional 10% tariff on Chinese goods. The tariffs were announced abruptly to begin on February 1st and represented a substantial uptick in tariff policy even by Trump's first term standards. Canada, Mexico, and China are the US's three largest trading partners and the tariffs against Canada and Mexico were particularly confusing to economists. Markets sold off on January 31st as the tariff announcement came into focus and more heavily when markets opened on February 3rd as the Trump administration began steps for implementation. However, after calls with leaders in Mexico and Canada and nominal steps by each country to address border security,

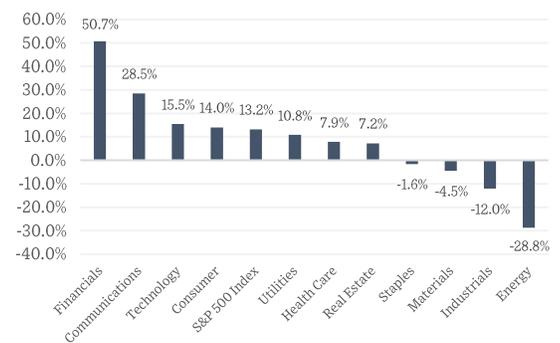
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President Trump announced a 30-day delay in the tariff implementation and markets recovered. More aggressive tariff policy hits at the heart of the market's confidence in Trump economic policies. Business confidence skyrocketed after Trump won the election in 2016 and 2024 on the belief businesses would see less regulation and lower taxes. Markets struggled in 2018 as the Trump administration ramped up tariff efforts that were primarily focused on China. Trump campaigned on stronger tariff rhetoric this time around noting the economy grew during his first administration, inflation remained low pre-Covid, and the Biden administration maintained his tariffs on China. As tariffs towards China ramped up in 2018, and supply lines were impacted by Covid-19 in 2020, trade with Mexico has increased significantly to replace China. Canadian trade has been in a long-term decline primarily on higher US energy production and lower average energy prices, but exposure has ticked up since 2020. US Companies have generally relied more on "nearshoring", i.e. bringing supply lines closer to the US for ultimate consumption than Trump's preferred "onshoring". Indeed, industries like US automakers are intertwined between the three countries with an Economist article citing some vehicle production that involves components crossing US borders as many as *seven times* during the production process. There is no current tariff exception for multiple border crossings, as written the tariffs would have been assessed at each part of production. A Barclays analysis estimated that the "Big Three" automakers (Stellantis, General Motors, Ford) would see a complete elimination of their annual profits from a 25% tariff if they did not raise prices on vehicles. President Trump seemed to acknowledge in social media postings there could be some "pain" for US consumers while still promising a glorious future. It is less clear what the President is trying to receive in return from our neighbors, he had already renegotiated the North American Free Trade Agreement (NAFTA) during his first administration with the United States-Mexico-Canada Agreement (USMCA) that was signed in 2020. Any new deal as a result of tariffs would be an update to his prior deal. This may raise the question for foreign governments whether it is worth signing trade agreements with the US as well as diluting the business confidence that President Trump has received to date.



Percentage of Total US Imports: China, Mexico, and Canada
Source: Strategas, US Census. Data for 2024 is based upon first 10 months.

4th Quarter 2024 Earnings Season is in full swing as we enter February and initial earnings reports and overall growth have met expectations. As of January 31st, 2025, only 36% of S&P 500 companies had reported earnings, but earnings growth was running above 13% versus the 4th quarter of 2023. That earnings growth level would be the highest percentage since the 4th quarter of 2021 when companies were comparing themselves to Covid-impacted earnings. Driving the earnings growth are the typical sectors investors have been bidding up in Technology, Communications and Consumer, but joining the party recently has been the Financial sector which is topping the S&P 500 Index with 51% year-over-year earnings growth as of January month-end. Strong earnings from big banks in January propelled banks to the top sector performer to start 2025, gaining just under 9% in January. Financials performed well initially during President Trump's first administration as they benefited from deregulation and lower US corporate tax rates. The second administration we believe may be similar. Large banks benefit from the uptick in economic activity, a steeper yield curve, increased capital market transactions like trading and Initial Public Offerings, as well as mergers and acquisitions we believe will increase. Banks are also



S&P 500 Index Annual Earnings Growth by Sector (4Q24)
Source: FactSet data as of 1/31/25.

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less exposed to the “bad” of Trump policies in tariffs and non-US revenues. Banks do have risk, and any downturn in the economy or credit cycle would be a negative and likely lead to financial sector underperformance. We do not believe those risks are as prominent in the near-term. Overall earnings are expected to grow 15% in 2025 for the S&P 500, one of the reasons we believe markets should be able to maintain their positive outlook despite what is clearly going to be a more volatile environment. We will continue to watch earnings closely, but early reports are encouraging for 2025 market outcomes.

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